

Systemic Risk:
Understanding the Problem is the First Step to a Policy Response

By

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Thank you. My name is Allan and I am a recovering economist.

We are still only part way through the greatest financial collapse we have experienced since the Great Depression. We have avoided a complete economic collapse only because of last minute, heroic efforts on the part of the federal government and the Federal Reserve. Storied names from the world of finance have disappeared in the blink of an eye, yesterday's heroes are today's villains (Angelo Mozilo), and money still, for the most part, only flows with a federal guarantee.

How did we get into this mess? How did we wind up exposing the taxpayers to outlays and contingent liabilities that exceed \$3 trillion? How did trillions of dollars of wealth – accumulated over decades - get wiped out? How did so much economic pain get inflicted on a broad swath of households who now owe more on their homes than their homes are worth? How have so many people been put out of work and their lives upended?

When people talk about systemic risk and systemic collapse they generally refer to how the failure of one or more interconnected institutions spread costs and collapse through the financial and economic system. I would like to put somewhat of a different interpretation on the term for the purposes of today's discussion. The systemic failure in this crisis began when virtually all of the critical components in the system that make a market economy work ceased to function as expected. Understanding this reality puts a new perspective on the risks that the economy and regulators face in trying to prevent such events from reoccurring.

What ceased to function?

Financial Institutions: they were supposed to identify risk, quantify risk, price risk, take on appropriate risk, and reduce concentrations of risk. They failed miserably in their task. Risk was mis-priced, bought and sold, and concentrations were built up without regard to the long run implications to the firms. Firms that were supposed to be relied on to act with enlightened self interest turned into kamikaze financiers.

Accountants (and the FASB): they were supposed to provide the metrics by which the conditions of publically traded companies would be transparent to the market. They did the opposite. The accounting rules, in fact, as they developed over the past two decades became a system that drove an ever wider wedge between the GAAP numbers of a business and the true economic condition of a business. Business leaders made suboptimal business decisions in order to get good GAAP numbers. Those in private equity ignored the GAAP numbers and focused on what was important – free cash flow. Accountants who used to be professionals, expressing their professional opinions based on a modest set of principles, became compliance officers – with every complex question about the books of a firm referred back to the central office for a ruling by the expert on the particular opaque accounting standard in question.

Rating agencies (or as they are known in the regulatory world, NRSROs): they were supposed to make arms-length disinterested judgments about the credit quality of firms and securities. Instead they developed a lucrative business in consulting with issuers of asset backed securities about how to qualify for AAA and AA ratings. Qualifying for the desired high rating became a game of figuring out the school solution – for which the teacher was paid to help you do it. The irony of this is that the investment banks viewed the rating agencies with contempt – I was told many times that the rating agencies hired people whom the investment banks would never hire. The outcome of this failure was almost unbelievable: equity tranches of CDOs were rolled together into CDOs squared and in the process tranches with the highest risk of loss were turned into AAA assets. The Medieval alchemists had the right idea – they were just focusing on the wrong materials. Rather than trying to turn base metal like lead into gold, they should have focused on turning worthless paper into gold, or in the case of the current crisis, AAA securities.

Investors: they were supposed make investment decision based on calibrating risks and returns. They basically ceased to independently assess risk (there is a question, in the case of individual retail investors, as to whether they can ever be expected to do this.). They threw any semblance of informed decision making to the wind and made decisions based on rating agency ratings. Even when the market signaled a disconnect between ratings and risk – as when assets yielded above market returns for the ratings of the assets, they were not stayed.

Borrowers: Households went into debt and assumed debt service levels that they could never repay. This was especially true with respect to mortgages and home equity lines. There has been a lot of public debate over this issue that is akin to the story of the grasshopper and the ants over whether to help these homeowners. Why should the responsible ant households bailout the irresponsible grasshoppers? The usual answer is that society (including the responsible ant households) will be hurt by high levels of foreclosures and the collapse of neighborhoods with high levels of foreclosures. I would also add that, for the most part, households know very little about finance, and take out mortgages so infrequently they do not really understand what they are doing. They go to a bank or a mortgage broker in the same way they go to a doctor when they are sick, or a lawyer when they have a legal problem. They view the mortgage originator as a trusted expert agent who will do the right thing for them. And, for the majority, I believe they were as victimized as anyone else.

The Economics profession: the theory of efficient markets gained such widespread acceptance that it was barely challenged in the discipline. And, this widespread acceptance created a policy commitment to the model at the government level. Financial markets were viewed as perfect and self-correcting. At any point in time the market price was the correct price because it reflected all know information. I am sure you have all heard the joke about the two economists walking down the street and one spots a \$20 bill lying on the ground. He mentions his observation to the second one. The response from the second economist was: “If there were a \$20 bill lying on the pavement someone would have picked it up, so obviously it cannot be there.” And the two walked on...

Government in General and Regulators in Particular bear their fair share of the responsibility. Here there are multiple failures. From the broader governmental perspective there were failures based on ideology and philosophy. From the regulatory policy perspective there were conceptual and analytical failures, and in the execution of regulatory responsibilities there were further failures and weaknesses.

At the **government-wide level** the crisis happened at the end of a quarter century of ideologically based decision making – as opposed to decisions based on hard careful evaluations of data and credible analysis. Simply put, the view that took hold was that markets are perfect and government cannot do anything except make things worse. (For example, examiners at the NY Fed were told that the banks they were examining knew what they were doing and that they should not cause any trouble.) This approach reflects a stream in economics I refer to as the Neanderthal School of Economics, the analytical depth of which gets no deeper than “Market Good! Government Bad!” These are the economic fundamentalists who believe that Moses received the Wealth of Nations at Mt. Sinai along with the Ten Commandments. The problem with this approach is that it always leads to the classic failure of intelligence: when there is a conflict between the data and the paradigm through which you interpret the data, you throw out the data (for example, the 1973 Mideast War). In 2003 Ned Gramlich (the Fed Governor with the consumer protection portfolio – and a very distinguished economist in his own right) went to Alan Greenspan 2003 to report that he was seeing things in the mortgage market that were very troubling. Gramlich told Greenspan that the Fed had the legal authority to address the problems he was seeing and should use it. Greenspan’s response was “Go away, we are not going to do that.” That ideology gained political traction and over a quarter century of success in scaling back the governmental rules and laws designed to prevent the type of crisis that occurred. The triumph of this school of thought was so complete that when the facts on the ground pointing to an economic catastrophe became so overwhelming, the administration in place lacked the policy framework for how to respond to the crisis. Their initial response made things worse because they did not understand how their actions in saving Bear Stearns (March 2008) changed market perceptions of the rules of the game. Later responses appeared to be no better than flailing around grasping for something to do without being able to explain how it would make a difference. In August of 2008 I published an op-ed in the American Banker making the case that by saving Bear Stearns the administration had fundamentally changed the rules of the game. Until Bear was saved, the specially privileged class of financial market participants consisted of insured depositories and their depositors. The depository world paid for their privileges by being subjected to regulation, intrusive examinations, and being taxed to fund the deposit insurance fund. By saving Bear, the government established the precedent that the counterparties to derivative transactions would be protected as well – but without either equivalent regulation of the investment banks or the investment banks having to pay for the risk sharing that went along with the implied guarantee. That was not a sustainable situation and had to be corrected. When Lehman tottered on the edge, Treasury Secretary Paulson let it go down (September 2008) because he **believed** the market had long been aware of Lehman’s weaknesses and he **believed** that market participants had plenty of time to adjust their exposure to Lehman. He had no data on the matter – he was making decisions based on “belief” and ideology rather than hard data and analysis. He seemed to be oblivious to how saving Bear had altered everyone’s expectations and behaviors. That decision turned a difficult

situation into a calamity, and the next day the federal government spending almost \$200 billion to prop up AIG.

At the **regulatory level** there were significant failings at the conceptual and implementation levels.

At the **Conceptual level:**

The regulatory community **failed to either define or monitor systemic risk.**

- They thought that if they focused on the safety and soundness of individual institutions the financial system overall would be fine. That is simply not the case; the whole is greater than the sum of the parts. Understanding and monitoring Systemic risk must focus on both individual institutions, and the system overall.

The regulatory community placed **excessive reliance on GAAP and GAAP measures of capital.**

- Accounting capital is a poor measure of solvency
- It is backward looking versus forward looking

Regulators placed inadequate focus on the **probability of insolvency.**

- Insufficient attention to leverage, cash flows, and liquidity
- Hanging on to old analytical approaches long after they cease to be credible.

Weaknesses in **Implementation of Regulation include:**

Inadequate data

- Lehman decision
- Response to Madoff allegations

Insufficient capacity for risk analytics

- 401k QDIA safe-harbor decision of 2003

Gaps between regulators' reports and financial condition

- OFHEO (the regulator of Fannie Mae and Freddie Mac) issued a mandated solvency report in July 2008 stating that the enterprises were "Well capitalized." However, a few weeks later both Fannie Mae and Freddie Mac were put into conservatorship.

Outsourcing of regulation

- Internal risk models (e.g. Basel II, stress tests)
- Model Risk: misspecified/misused models (e.g. VAR)
- NRSROs: relied on them to identify risk (Comptroller John Dugan - "With risk based supervision we don't waste time on AAA securities", i.e. the rating agencies are determining what the OCC examiners look at.
- Rating Agencies: blurring of role of rating agency and the issuer (consulting).

RESPONSE TO THE CRISIS:

Everyone accepts that something has to be done – but that is where the agreement stops. The financial sector has not owned up to its responsibility for the crisis – even when institutions have survived only with massive infusions of public capital. The government’s proposals have not focused on the central requirements on how to fix the situation:

The **public debate** has focused on:

- **The Washington turf wars** – who will be the systemic regulator
- The authorities of the systemic regulator
- Who will be regulated – “Systemically important institutions”
- On- versus off exchange trading of derivative
- Creating a consumer financial product safety agency

Absent from the debate is a discussion of:

- Data Requirements
- Analytical capacity requirement to effectively regulate systemic risk and individual financial institutions.
- How the systemic regulator (whoever it is) will measure, monitor, and manage systemic risk.

IT IS FOR THESE REASONS I HAVE BEEN FOCUSING FOR THE PAST FEW MONTHS ON AN EFFORT TO CREATE A NATIONAL INSTITUTE OF FINANCE (NIF): www.ce-nig.org

The NIF will be a federal agency working for the Systemic Risk Regulator and the broader financial regulatory community which will create and maintain a national data repository of financial transaction and entity position data and the analytical capacity to take full advantage of that data and turn it into useful information for both systemic risk regulation and independently assessing the financial condition of individual entities.