

Do We Really Need a Systemic Regulator?

Based on what we now know about AIG, it's unclear 'too big to fail' institutions are in fact too big to fail.

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The principal assumption underlying the financial regulatory reform legislation working its way through Congress is that certain financial institutions are "too big to fail" because of the severe consequences of "interconnectedness"—a word that entered our lexicon during the financial crisis.

The problem is presented as follows: There are major financial institutions that are systemically important because their failure can, due to interconnectedness, bring down other large financial institutions. A chain reaction of such failures is unacceptable since it would disrupt our economic system. The chain reaction must be stopped after the fact by the use of taxpayer-funded bailouts that avoid the kinds of losses for investors or counterparties that would normally occur in bankruptcy. Finally, taxpayers need to be protected by new regulations designed to protect against the failure of these major institutions.

But how severe is the threat from interconnectedness? Last month's report by the Special Inspector General for the Troubled Asset Relief Program (Sig tarp) on AIG is illuminating. While the report's focus is on whether Goldman Sachs unduly profited from the Fed's rescue of AIG, more significant is its discussion of why AIG even received an \$85 billion rescue. It does not appear to be because counterparties would have failed as a result. According to the report, Goldman had adequate collateral to protect itself against an AIG default. Indeed, the collateral was cash whose value would not have been decreased by a "rush to the exits." There is no reason to assume other counterparties did not follow similar collateral practices.

Viewed in this light, FDIC Chair Sheila Bair's proposal to increase the losses secured counterparties must bear in case of a financial institution's failure seems misguided. Counterparties whose exposure to credit losses is fully backed by collateral are after all "secured." Treating them as if they were unsecured—forcing them to take a "haircut"—in the case of a financial institution's failure would only increase the risks of chain reactions.

An amendment to the House bill ("The Wall Street Reform and Consumer Protection Act") very likely to be adopted today fortunately exempts most derivative contracts from haircuts. But it fails to exempt all short-term repurchase agreements ("repos"). Short-term repos are normally fully secured; if lenders know they will have to take a haircut they will be less likely to extend credit to financial institutions most in need.

Sigtarp further reports that the Fed and the U.S. Treasury were actually more concerned with \$88 billion of AIG investor and debt-holder losses: \$10 billion on loans by state and local governments; \$40 billion for workers in 401(k) plans; and \$38 billion for retirement plans. Certainly, these losses would be "connected" to an AIG default. But they did not involve the

threat of a chain reaction of financial institution failures. The auto company bailouts also had little to do with the fear of devastation to the financial system.

If large losses by institutional investors and other stakeholders are the real reason why we are concerned with interconnectedness and "systemic risk," then we would have to regulate all large global corporations, not just financial ones, whose failures could trigger similar losses—an impossible task.

The Sigtarp report does mention concern with losses to money market funds, principal holders of \$20 billion in AIG commercial paper. It is certainly possible that an AIG default right on top of the Lehman bankruptcy could have led to more money-market funds falling below \$1 per share and have intensified the irrational run on funds generally. The answer to the run problem was not to rescue AIG but rather for the government to use, as it did, its lender of last resort powers to stem the runs.

Clearly we need to know far more about the facts of interconnectedness. As a starting point, Congress should require Fed Chairman Ben Bernanke and Treasury Secretary Tim Geithner to give the American people a complete account, with supporting documentation, of why the Fed and Treasury thought it was important to rescue AIG. This account should include a detailed analysis of counterparty exposure to the extent this is claimed to have played a significant role in their decision.

If it turns out that there are no severe consequences to the financial system from interconnectedness, then do we really need to control the risk of large financial institutions by imposing heightened capital or new liquidity requirements? Indeed, why would we need a systemic-risk regulator at all? Congress, as part of its reform legislation, should mandate the creation of a new expert commission designed to fully investigate the extent and consequences of interconnectedness before any new regulation of systemically important institutions is actually adopted.

Without real adverse consequences from interconnectedness, the too-big-to-fail problem becomes much more manageable. Public money might still have to be injected into a failed institution to avoid a sudden economic disruption, but this would only be after losses were fully imposed on the private sector without fear of a chain reaction. Thus, we could avoid the untenable situation of private gains and public losses that we have persuaded ourselves we are faced with today.

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