Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Putting the Cart before the Horse[*]

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March, 2011

The Financial Stability Oversight Council has started the process of identifying nonbank financial companies that may pose systemic risk. In doing so, the Council has put the cart before the horse. It has undertaken a major task related to systemic risk before it has defined what constitutes systemic risk. The Council should define systemic risk before it identifies systemically important nonbank companies or takes other actions related to systemic risk.

In one of its first official acts, the Council has started the process of identifying nonbank financial companies that may pose systemic risk. It has published a proposed rule on the procedures and criteria it will follow in making such a determination. This is just one of many of the Council's duties related to systemic risk. Others include the collection of information to assess risks to the financial system, the identification of potential threats to financial stability, the identification of gaps in regulation that pose risk to financial stability, and the development of heightened prudential standards for systemically important nonbanking and banking companies to mitigate risks to financial stability.

All of these actions require a clear understanding of what constitutes systemic risk. Absent such a clear understanding, the Council runs its own risk of basing determinations or taking actions that are not appropriately targeted or even contribute to systemic risk. In its proposed rule, however, the Council has provided little guidance on this important question.

Congress recognized the importance of defining systemic risk. The Dodd-Frank Act specifically states that one of the fundamental purposes of the Council is "to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial

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companies, or that could arise outside the financial services marketplace." Therefore, before it identifies systemically important nonbank companies or takes other actions related to systemic risk, the Council should define systemic risk.

Admittedly, defining systemic risk is not an easy task. Many factors can influence systemic risk, and these factors can change from time to time based upon economic and market conditions. However, since the financial crisis, academics and regulators in the U.S. and EU have produced a variety of papers on the topic. For example, Reinhardt and Rogoff have produced a comprehensive analysis of banking crises that identifies some recurring patterns (e.g., asset bubbles, credit booms, and capital inflows) that could serve as key markers in defining systemic risk. (*This Time is Different: Eight Centuries of Financial Folly*). Likewise, papers on measuring systemic risk have been produced by a group of professors at the NYU Stern School of Business (*Measuring Systemic Risk*, May 2010), the Bank for International Settlements (*Measuring the Systemic Importance of Interconnected Banks*, March 2011), and the Bank of England (*Mapping Systemic Risk in the International Banking Network*, March 2011), among others. Additionally, Greg Wilson and I co-authored an analysis of systemic risk for the Financial Services Roundtable that sought to define the term and focus the activities of the Council (*Systemic Risk Implementation: Recommendations to the Financial Stability Oversight Council and Office of Financial Research*, September 2010).

This body of work does not reach a common conclusion, and should be subject to critical analysis. Nonetheless, it illustrates the scope of attention that is being devoted to defining and measuring systemic risk. The Council should undertake its own review of this issue, and, in the process, should sponsor public forums on the topic. It should then publish, for comment, a definition of systemic risk that will guide its determinations and other policy actions.

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