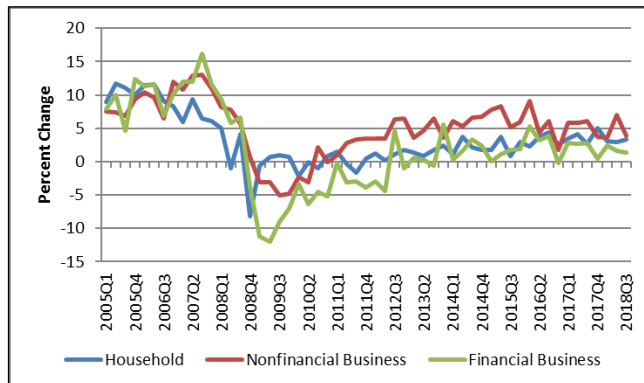




Introduction to Financial Services: Systemic Risk

The 2007-2009 financial crisis was characterized by a system-wide breakdown in financial stability. Overtaken by panic, financial market participants became unwilling to engage in even routine transactions at the height of the crisis. The result was a sharp and long-lasting contraction in credit, as shown in **Figure 1**, and economic activity.

Figure 1. Private-Sector Credit Growth, 2005-2018



Source: Federal Reserve, Z.1 Data Release, Table D. 1.

Note: annualized percentage change from previous quarter

In the aftermath of the crisis, one priority for policymakers was to contain systemic risk. In other words, how could threats to financial stability be identified and neutralized? Systemic risk (also called *macroprudential*) regulation seeks to prevent both future financial crises and more modest breakdowns in the smooth functioning of specific financial markets or sectors. It can be contrasted with the traditional *microprudential* regulatory focus on risks to an individual institution's solvency.

Sources of Systemic Risk

The recent financial crisis highlighted that systemic risk can emanate from financial firms, markets, or products. It can be caused by the failure of a large firm (hence, the moniker "too big to fail") or it can be caused by correlated losses among many small market participants. Although historical financial crises have centered on banks, nonbank financial firms were also a source of instability in the recent crisis. Daniel Tarullo, a former Federal Reserve governor, placed the sources of systemic risk into four categories:

- **Domino or spillover effects**—for example, when one firm's failure imposes debilitating losses on its counterparties.
- **Feedback loops**—for example, when fire sales of assets depress market prices, thereby imposing losses on all investors holding the same asset class. Another example is deleveraging—when credit is cut in response to financial losses, resulting in further losses.

- **Contagion effects**—for example, a run in which investors suddenly withdraw their funds from a class of institutions or assets. Banks and some other financial firms are vulnerable to runs because their assets (e.g., loans) are less liquid than their liabilities (e.g., deposits).
- **Disruptions to critical functions**—for example, when a market can no longer operate because of a breakdown in market infrastructure.

Boom and bust cycles in asset values or credit availability can often be the underlying cause of these four outcomes, with the bursting of the housing bubble in the recent crisis a notable example. But one can also imagine other events unrelated to asset values, such as a successful cyberattack on a critical market, triggering systemic risk.

Policy Response to the Crisis

Critiques of inadequate systemic risk regulation in the run up to the crisis can be placed into two categories: (1) insufficient regulatory authority to identify or mitigate systemic risk, partly because of financial market opacity; and (2) shortcomings of the regulatory structure that made it unlikely for regulators to successfully identify or respond to systemic risks. Critics argued that in the fragmented U.S. regulatory system, no regulator was responsible for financial stability or focused on the bigger picture, and regulators' narrow mandates meant that there were gaps in regulatory oversight.

The 2010 Dodd-Frank Act (DFA; P.L. 111-203) sought to enhance regulatory authority to address specific weaknesses revealed by the crisis and to modify the regulatory structure to make it forward-looking and nimble enough to respond to emerging threats. Major changes include the following:

FSOC. DFA created the Financial Stability Oversight Council (FSOC), headed by the Treasury Secretary and composed of the financial regulators and other financial officials. FSOC was tasked with identifying risks to financial stability, promoting market discipline by eliminating expectations that the government will prevent firms from failing, and responding to emerging threats to financial stability. DFA created the Office of Financial Research to support FSOC.

Generally speaking, FSOC does not have rulemaking authority to intervene when it identifies emerging threats to stability. When one of its members has the relevant authority, FSOC can recommend—but not require—the member to intervene. Otherwise, it can recommend a legislative change to Congress. It is required to produce an annual report (on which the Chair testifies) to Congress, where it catalogs emerging threats and recommendations.

TBTF. DFA sought to end “too big to fail” (TBTF) and the systemic risk it posed. FSOC’s primary regulatory authority is the ability to designate nonbank financial firms and payment, clearing, and settlement systems as systemically important. The former are referred to as systemically important financial institutions (SIFIs) and the latter as financial market utilities (FMUs). From 2013 to 2014, four firms, three of which were insurers, were designated as SIFIs. Between 2016 and 2018, all four were de-designated. There are currently eight FMUs.

Under the DFA, designated SIFIs and all bank holding companies with more than \$50 billion in assets were subject to enhanced prudential regulation by the Federal Reserve—special safety and soundness requirements (e.g., living wills and Fed-run stress tests) that do not apply to other firms. P.L. 115-174 created a graduated threshold of \$100 billion and \$250 billion, thus reducing the number of banks subject to enhanced regulation. In addition, under Basel III (an international agreement implemented domestically through rulemaking), the very largest banks are subject to additional capital and liquidity requirements that do not apply to other firms. Collectively, these DFA and Basel III requirements aim to make it less likely that large financial firms will fail, given the systemic risk that their failure could pose.

In addition to reducing the likelihood that large firms would fail, DFA also attempted to make it less disruptive if they did fail. As an alternative to bankruptcy, DFA created a resolution regime for nonbank financial firms if their failure posed a risk to financial stability. The new resolution regime, called Orderly Liquidation Authority (OLA), is modeled on the FDIC’s bank resolution regime, with key differences, and is administered by the FDIC.

Opacity. DFA enhanced the transparency of certain markets to regulators and the public (e.g., new reporting requirements for hedge funds and derivatives).

Derivatives. By subjecting derivatives markets to reporting, capital, clearing, and exchange requirements, DFA attempted to preclude another buildup of large, sudden losses by derivatives participants, such as AIG experienced.

Current Policy Debate

Through the creation of FSOC and the enhanced regulation of SIFIs and banks with more than \$50 billion in assets, the DFA put an institutional structure in place to address systemic risk. Arguably, in practice, this structure has not worked as envisioned, however. The DFA regime envisioned that (1) emerging threats to financial stability would be identified by FSOC and addressed by the regulators or Congress and (2) systemic risk posed by large financial firms would be mitigated through the Fed’s enhanced regulation and their failure would be managed through OLA.

In practice, from 2010 to 2018, FSOC has issued only one formal recommendation to a member agency to address systemic risk (SEC money market reforms, adopted in 2014). Each annual report contained multiple recommendations to member regulators that mostly serve as an update on initiatives that regulators were already

undertaking. In contrast, this coordination of the regulatory agenda may help avoid regulatory gaps. The report has also included a smaller number of legislative recommendations to Congress, notably in the areas of housing finance reform and cybersecurity. Generally speaking, recent Congresses and the current Administration have favored reducing existing financial regulatory requirements, not introducing new ones. Further, the number of large firms subject to enhanced prudential regulation was reduced by the de-designation of all four nonbank SIFIs and by raising the \$50 billion threshold in P.L. 115-174.

Going forward, the current Administration has suggested that *activities-based regulation*—regulating particular financial activities or practices to prevent them from causing financial instability—is a more appropriate way to address systemic risk for nonbanks than *institution-based regulation* (i.e., SIFI designation). (These two approaches need not be mutually exclusive.) This approach would require FSOC to make policy recommendations and regulators or Congress to adopt them, although as noted that has happened rarely to date.

Criticisms of the current regime include (1) its success depends on policymakers accurately identifying and responding to emerging threats, although they failed to do so before the financial crisis; (2) it reduces the role for market discipline in discouraging systemically risky behavior and may inadvertently increase perceptions that large firms are too big to fail (i.e., the government will bail them out); and (3) it imposes costs that may unduly increase the price or reduce the availability of credit. According to the 2017 FSOC Annual Report, “The U.S. financial regulatory system should promote economic growth not just by preventing financial crises that reduce growth, but also by minimizing those regulations that increase costs without commensurate benefits.”

One challenge to assessing the effectiveness of systemic risk regulation is that periods of financial instability or breakdown are rare. Financial markets have generally been stable since post-crisis reforms were implemented, which could be a sign of success. But, as a cautionary tale, the period of stability before the financial crisis masked systemic risk that only became evident when it was too late.

CRS Resources

CRS Report R45052, *Financial Stability Oversight Council (FSOC): Structure and Activities*, by Jeffrey M. Stupak.

CRS Report R42150, *Systemically Important or “Too Big to Fail” Financial Institutions*, by Marc Labonte.

CRS Insight IN10997, *Activities-Based Regulation and Systemic Risk*, by Marc Labonte and Baird Webel.

CRS Insight IN10982, *After Prudential, Are There Any Systemically Important Nonbanks?*, by Marc Labonte and Baird Webel.

Marc Labonte, mlabonte@crs.loc.gov, 7-0640

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