We Had a Systemic Risk Regulator, It Did Not Work, It is Still a Bad Idea

Clifford S. Asness, Ph.D.
AQR Capital Management, LLC

Last updated: 4/30/2009
Comments welcome: comments@stumblingontruth.com
Updated versions available at: StumblingOnTruth.com

One popular cry these days is that we need a government-empowered nationwide "Systemic Risk Regulator." In effect, that we need to create the financial version of Homeland Security. However, before we build another giant government bureaucracy and appoint another "Czar" with his own Okhrana, we should pause.

We actually had a de facto systemic risk regulator for the last 20 years or so. His name was Alan Greenspan. In the face of both the tech bubble and the recent real estate/credit bubble there were multiple calls for him to slow things down before the ultimate crashes. "Please raise interest rates." "Please raise margin requirements" (tech bubble). "Please jawbone the markets" (he infamously tried that once in 1996, but he let rising stock prices and some good productivity data convince him he was wrong).

I'm not seeking to blame Greenspan alone here. I certainly cannot prove I would have done any better. The point is we had someone on the job, someone with tremendous talent and credibility, someone actively trying to assess whether each of these orgies was in fact a true bubble -- and he could not make that call until it was too late. Of course, it's a lot easier with hindsight. For everyone so sure "Wall Street bankers" acted irresponsibly, I present Congress with all its raging anger, conveniently ignoring that many of its own members assured us everything was fine until just after it all blew up. It's harder playing the game real-time.

So, for the last two bubbles we had the Maestro looking and giving the all-clear sign. Would a Risk Czar have worked better? Is he going to be smarter than Greenspan and know when things are bubbles and when they are not? Will he know when actions might be precipitous and choke off economic growth (still the best anti-poverty program ever devised)? Is anyone that good? No one in the history of government or industry has been.

One difference is that this proposed new regulator is not just about spotting bubbles, but about identifying companies that are "too big to fail", and thus present systemic risk, and then "doing something" about them beforehand. First, this task can't really be separated from spotting and preventing bubbles. It is precisely the danger of bubbles and their popping that historically has caused "systemic" risk to be unveiled, and even then it has been exaggerated in an attempt to scare people into allowing more government power (remember how we were told LTCM and their "systemic" risk would have brought down the economy if not saved, while looking back now their four billion dollar loss seems almost quaint?). Next, it seems quite startlingly naïve to think that a new government bureaucracy is going to be able to look into the heart (or balance sheet) of all companies, decide which are "systemically relevant" and move logically, but not unfairly, to curtail any risk they represent, presumably using some coercive powers. That is an exceedingly complex and difficult undertaking in which we should have little confidence. Government entities have no history of doing anything like this endeavor. While it cannot be proven, as it is hard to prove a negative, this is quite likely to end up looking like Congress running the DMV. Bureaucracy, blame, shouting, horrific inefficiency, and a frustrating way to kill half a day on line waiting for your license to take risk...

Perhaps scariest, adding such a regulator only magnifies the moral hazard problem as the government effectively will be promising that systemic dangers won't strike again. This new insurance policy could induce more unwarranted risk-taking, making the taxpayer even more deeply on the hook when something eventually blows up. And, if that moral hazard does not lead to more risk-taking, it will only be because the regulator, correctly deducing he has all downside and no upside, neuters the financial system of all risk, devastating growth and innovation.

If we are to spend energy "fixing" markets, let's spend it learning how to wind down a failed "systemically relevant" institution better. When Lehman Brothers failed, the participants in the financial system ran around like chickens with their heads cut off. It wasn't so much that the systemic linkages between firms meant massive losses, it was that nobody knew precisely what positions they held or what contracts they had on and with whom, and how their positions and trades would be treated. Essentially, it seems pretty clear that none of the regulators, lawyers, bankers or traders had really given enough thought as to what to do in the event of failure of a complex financial intermediary. As a practical matter, we all assigned zero probability to it.

Serious people devoting serious time to the nuts and bolts of what happens next time someone "too big to fail" indeed fails would be an incredibly productive exercise. It is hard to imagine us collectively perfecting this process to the point of having seamless bankruptcies involving huge intertwined multinational institutions. However, it is even harder to imagine that we cannot get far better at this than we are now.

Now, here's the magical part, the better we get at it, the more the "too big to fail" concept goes away, and any need for "systemic" risk regulation. We could then lean more towards allowing the market to sort out its own messes, have investors who chose poorly bear their own losses, and even bonuses, if improperly distributed, be judged not in the court of popular opinion, or god-forbid the kangaroo court of Congress, but rather where they are meant to be, in bankruptcy court. Spending our time on this instead of the government program of the week seems like a highly positive trade-off. I really hope I'm not now sued by the Kangaroos for defamation...

Rather, the current plan is to set up yet another government agency, which will expand over time while failing miserably at its near-impossible appointed task. To put it simply - too many Czars spoil the republic.

Well, one good thing will come out of this all. Next time we can all just blame the Systemic Risk Regulator.