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Introduction to Financial Services: Systemic Risk

Recent Episodes of Financial Instability

The 2007-2009 financial crisis was characterized by system-wide financial instability. Overtaken by panic, market participants became unwilling to engage in even routine transactions at the height of the crisis. Distress at large financial firms was central to the crisis. Financial stability was not restored until large-scale financial intervention by the Federal Reserve (Fed) and Congress helped stabilize markets and provided assistance to financial firms. The result was a sharp and long-lasting contraction in credit and economic activity.

The Coronavirus Disease 2019 (COVID-19) pandemic also caused significant financial market turmoil in spring 2020, as investors were faced with uncertainty and unprecedented disruptions to economic activity. But this time, financial stability was quickly restored, albeit again through large-scale financial intervention by the Fed and the CARES Act (P.L. 116-136). Unlike the previous crisis, distress at large financial firms was not central to the instability. Both episodes suggest that financial markets remain inherently fragile under periods of stress, and federal interventions are likely in future episodes of instability. This raises questions of whether further reforms are merited to mitigate systemic risk and whether federal interventions are acceptable.

Sources of Systemic Risk

The 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 also were a source of instability in the financial crisis. Daniel Tarullo, a former Fed 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 often can be the underlying cause of these four outcomes, with the bursting of the housing bubble in the financial crisis a notable example. Other events unrelated to asset values, such as a successful cyberattack on a critical market, also could trigger financial instability.

Policy Response to the Financial Crisis

In the aftermath of the financial crisis, one priority for policymakers was to contain systemic risk. In other words—how might threats to financial stability be identified and neutralized? Systemic risk (also called *macroprudential*) regulation seeks to prevent both future financial crises and 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.

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 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 included the following:

Financial Stability Oversight Council (FSOC). DFA created 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.

"Too big to fail" (TBTF). DFA sought to end 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). There are currently zero SIFIs, but there were previously four (see **Table 1**). There are currently eight FMUs.

Table 1. Former Nonbank SIFIs

SIFI	Designation Date	De-designation Date
AIG	July 9, 2013	Sept. 29, 2017
GE Capital	July 9, 2013	June 29, 2016
Prudential	Sept. 20, 2013	Oct. 17, 2018
MetLife	Dec. 19, 2014	March 30, 2016 (by court ruling)

Source: CRS based on FSOC documents.

Under DFA, designated SIFIs and all bank holding companies with more than $50 billion in assets were subject to enhanced prudential regulation by the Fed—special safety and soundness requirements (e.g., living wills and Fed-run stress tests) that do not apply to other firms. The Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) replaced that threshold with a graduated threshold of between $100 billion and $250 billion, reducing the number of banks subject to enhanced regulation. In addition, under Basel III (an international agreement), 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 failures 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. Called Orderly Liquidation Authority (OLA), it is modeled on the Federal Deposit Insurance Corporation's (FDIC's) bank resolution regime, with key differences, and the FDIC administers it.

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.

Policy Debate

Through the creation of FSOC and the enhanced regulation of nonbank SIFIs and large banks, the DFA put an institutional structure in place to address systemic risk. Arguably, in practice, this structure has not worked as envisioned. 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, since 2010, FSOC has issued only two recommendations to member agencies to address systemic risk (SEC money market reforms, adopted in 2014, and GSE capital requirements, proposed in 2020). Each annual report contains multiple recommendations to member regulators that mostly serve as an update on initiatives that they were already undertaking. The report has also included a smaller number of legislative recommendations to Congress in some years, notably in the areas of housing finance reform and cybersecurity. Arguably, this coordination of the regulatory agenda helps avoid regulatory gaps but has not led to action on emerging threats. Generally speaking, recent statutory and regulatory changes reduced existing financial regulatory requirements and did not introduce 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.

In 2019, FSOC reoriented its approach away from *institution-based regulation* (i.e., SIFI designation) and toward *activities-based regulation*—regulating particular financial activities or practices to prevent them from causing financial instability—to address systemic risk for nonbanks. (These two approaches need not be mutually exclusive.) This approach requires FSOC to make policy recommendations and regulators or Congress to adopt them—although that has happened rarely to date, as noted.

Criticisms of the current regime include the following: (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) regulation imposes costs that may unduly increase the price or reduce the availability of credit. Events in spring 2020 highlight these challenges. Foreseeing the severity of the COVID-19 pandemic and its effect on financial stability was unlikely, and federal interventions to restore stability may encourage excessive risk-taking by market participants in the future.

CRS Resources

CRS Report R45052, *Financial Stability Oversight Council (FSOC): Structure and Activities*, by Marc Labonte

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

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