

Testimony of Robert C. Pozen  
Senate Committee on Homeland Security and Governmental Affairs,  
On the Need for a Systemic Risk Regulator

March 4, 2009

Mr. Chairman and Other Members of the Senate Committee:

I am Robert Pozen, Chairman of MFS Investment Management of Boston, Massachusetts. MFS manages mutual funds and pension assets for five million investors across the world. I am also a senior lecturer at Harvard Business School, where I teach courses on corporate governance and financial intermediation.

Thank you for this opportunity to testify before this Senate Committee on the need to monitor systemic risk and, if so, the best way to meet this need. I applaud the Committee for addressing this important subject at this critical time.

Systemic risk can be defined as the risk of a broad-based breakdown in the financial system – for example, where the failure of one large financial institution leads to the failure of others. Immediately below is a summary of my five main points. Then further below is the support for each of these points.

Summary

1. The United States needs one federal agency to play the role of systemic risk regulator because of the increasing frequency of global financial crises and higher correlations among different investment markets.
2. Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system.

3. The Federal Reserve Board should focus on five areas that are likely potential sources of systemic risk – inflated prices of real estate, institutions with high levels of leverage, new products falling into regulatory gaps, rapid growth in an asset class or intermediary and mismatches of assets and liabilities.
4. The Federal Reserve Board should monitor closely the activities of all types of financial institutions with very large or otherwise very risky assets since they are the ones most likely to impact the whole financial system.
5. If the Federal Reserve believes that actions need to be taken to reduce systemic risks, it should work closely with the regulatory agency with primary jurisdiction over the relevant institution, product or market.

#### Supporting Analysis

1. The United States needs one federal agency to play the role of systemic risk regulator because of the increasing frequency of global financial crises and higher correlations among different investment markets.

Within the last decade, we have witnessed two major financial crises in addition to the current one. The first was the Asian financial crisis in 1997-1998, which led to the Russian default on its ruble bonds and the near demise of Long-Term Capital, a large hedge fund. The second was the burst of the dot.com bubble in the United States, which led to a general decline in global stock markets in 2000 through 2002. More generally, Professor Barry Eichengreen of the University of California at Berkeley found 38 worldwide financial crises between 1945 and 1971, as compared to 139 financial crises between 1973 and 1997. Of these 139, 44 took place in high income countries.

In my view, the rate of global financial crises is likely to stay high or increase. The rapid pace of innovation in financial products presents a formidable challenge to all financial regulators. The low cost of financial transactions makes it easy to quickly

expand the trading volume in any security. Most importantly, the widespread globalization of finance has led to much higher correlations among different national stock markets and assets classes. In order to facilitate coordination among international financial agencies, it would be very useful to have one systemic regulator in the US.

2. Congress should give this role to the Federal Reserve Board because it has the job of bailing out financial institutions whose failure would threaten the whole financial system.

The doctrine of “too big to fail” used to apply only to banks because they are insured by the FDIC. Over the last year, however, the federal government decided that AIG, an insurance company, and Bear Stearns, an investment bank, should be bailed out by the Federal Reserve Board. After the failure of Lehman Brothers wreaked havoc in the short-term lending markets, it seems clear that the Federal Reserve Board will be asked to bailout any type of financial institution whose failure would threaten the whole financial system. If the Federal Reserve Board is going to bailout a broad array of financial institutions, and not just banks, it should have the power to monitor systemic risks so it can help keep institutions from getting to the brink of failure.

In addition, the Federal Reserve has a substantial portion of the resources and expertise necessary to monitor risks in the whole financial system. As part of its current functions, the Federal Reserve Board monitors economic indicators in the US and abroad. The Federal Reserve Board also has long experience in regulating banks and their holding companies. However, to be an effective systemic risk regulator, the Federal Reserve Board will need to develop significantly more expertise on capital markets and non-banking institutions. Because the Federal Reserve would be taking on broad new responsibilities, perhaps the function of setting mortgage disclosure rules should be transferred to a federal agency with a consumer protection mandate.

3. The Federal Reserve Board should focus on five areas that are likely potential sources of systemic risk – inflated prices of real estate, institutions with high levels of leverage, new products falling into regulatory gaps, rapid growth in an asset category or intermediary and mismatches of assets and liabilities.

While the Federal Reserve Board should look broadly at the whole financial system, it should focus on the five factors historically associated with financial crises in advanced economies. In Europe, Japan and the United States, financial crises have often started with sky-high prices of commercial and residential real estate financed by a credit boom. When those prices become unsustainable, the real estate market crashes. A real estate crash now reverberates through the financial system since so many mortgages are securitized and sold to investors.

Institutions with very high leverage ratios have the potential to cause a ripple effect throughout the financial system. For example, if an institution has \$100 billion in debt and only \$3 billion in capital, its capital can be reduced to zero if only a few of its large investments sour. Then it will be forced to sell billions of dollars of its assets to meet its debt obligations. These forced sales are likely to drive down prices for assets held by other financial institutions, which may in turn incur losses and start to sell assets.

As new financial products and institutions evolve, they can sometimes fall within the cracks of the regulatory system. A good example is a credit default contract, which was declared not to be an insurance or futures contract in 2000. Without a federal regulatory framework, the volume of credit default contracts soared and exceeded \$50 trillion by 2007. The Federal Reserve Board should monitor new products to close any regulatory gap before a systemic risk is created.

Similarly, if an asset class or intermediary experiences explosive growth, the Federal Reserve Board should understand the reasons for that growth. Between 2002 and

2006, for instance, there was a huge increase in the volume of new types of mortgage backed securities issued by off-balance sheet entities. We should have examined whether that rate of growth was sustainable.

A final indicator of systemic risk is a mismatch between long-term assets and short-term liabilities; this presents a fundamental challenge to institutional liquidity. In the S&L crisis, their assets were mainly long-term mortgages with fixed rates, but their liabilities were mainly short-term deposits with periodically changing rates. When deposit rates rose and mortgage rates stayed fixed, S&Ls became insolvent. In the current financial crisis, mismatches were again created by bank sponsors of special purpose entities, which sold short-term commercial paper to investors to finance long-term mortgages held by these entities. When investors became unwilling to roll over the commercial paper every 90 or 180 days, the bank sponsors were forced to provide liquidity support for these entities.

4. The Federal Reserve Board should monitor closely the activities of all types of financial institutions with very large or otherwise very risky assets since they are the ones most likely to impact the whole financial system.

The Federal Reserve Board should not confine its monitoring activities to banks; it should monitor any type of financial institution that is likely to create systemic risks. These are typically the very largest firms in each institutional category, although the correlation between size and risk may not hold in certain institutional categories. These categories include insurance companies, securities firms, pension plans, money market funds and hedge funds. For the small group of relevant firms in each category, the Federal Reserve Board should receive regular reports on their solvency and liquidity risks since they are likely to be granted access, if needed, to its discount window.

All these types of financial institutions already have a primary regulator, except for hedge funds. In my view, the managers of hedge funds over a certain size (e.g., \$100 million in assets) should be required to register with the SEC under the Investment Advisers Act of 1940. Such registration would not limit their investment strategies or prevent them from charging incentive fees to wealthy clients. In addition, a handful of very large hedge funds (e.g., over \$100 billion in assets) should submit to the SEC non-public reports with information relevant to systemic risks – e.g., leverage ratios and short positions – which would be passed on to the Federal Reserve Board.

It bears emphasis that the Federal Reserve and the primary regulator should keep confidential which specific institutions are being monitored for systemic risk. The public announcement that an institution is being monitored might lead investors incorrectly to assume that it will always be bailed out by the Federal Reserve Board. Conversely, investors might be unduly alarmed if they learn that an institution is being added to the monitoring process.

5. If the Federal Reserve believes that actions need to be taken to reduce systemic risks, it should work closely with the regulatory agency with primary jurisdiction over the relevant institution product or market.

The Federal Reserve Board should not become the primary regulator of very large hedge funds or other non-banking institutions. The Board has enough on its plate without taking on the general supervision of other types of financial institution, especially if there is a primary regulator with the relevant expertise. The Board should remain the primary regulator of state member banks and all bank holding companies.

If the Federal Reserve Board believes that it is necessary to limit the risks of a particular institution or product, it should explain its position to the relevant primary regulator. The primary regulator and the Board can then work together to impose the

necessary limits through appropriate measures. If the primary regulator and the Federal Reserve cannot agree on a course of action, the dispute should be resolved by the President's Working Group on Financial Institutions.

In addition, the FDIC should be given the power to supervise the bankruptcy proceeding for any systematically large financial institution. When Lehman Brothers became insolvent in 2008, it went through the normal bankruptcy process. This hindered federal regulators in dealing with the systematic ramifications of Lehman's failure.

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Thank you again for this opportunity to testify before this Senate Committee. Please feel free to ask any questions you might have.