On Systemic Risk

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Of all the massive corporate failures that precipitated our current financial crisis, AIG's stands out because it endangered the overall economy with such a large quantity of its distressed assets that the federal government felt obligated to spend $100 billion to bail it out.

The gravity of the AIG failure showed how institutions that are "too big to fail" are bad for our economy. We all see the pain rippling from AIG and the like in the form of climbing unemployment and a deep and potentially long recession. Simply put, our regulatory framework did not stand up to the challenge. We have a solution.

But first, some background. The risks still present in our economy are akin to the risks of the trusts of J.P. Morgan and others at the turn of the 20th Century. At that time, President Theodore Roosevelt determined that too much power over the economy was controlled by too few. Back then the "power" came in the form of monopolies, so Roosevelt created the Sherman Anti-Trust Act, which dissolved many monopolies and limited the influence of others.

Today, an overabundance of "power" over the direction of our economy comes from disproportionate concentrations of risk -- and a prime example is AIG. AIG's $377 billion of credit-default swaps (CDS) at the time of the government's intervention created grave economic stress in the U.S. and globally. Had AIG gone bankrupt, those swaps -- which are like insurance policies against the failure of other assets -- would have gone with it, and the potential spillover effect could have crippled the economy. Or at least so the government seemed to believe; it intervened before that could happen.

But intervention is, or at least should be, the action of last resort. Similar to the Sherman Anti-Trust Act, there needs to be a sort of "Sherman Anti-Systemic Risk Act" that creates a regulatory framework for preventing such extreme concentrations of risk, and avoids weekend financial fire drills by Treasury Department and Federal Reserve officials. Like the Anti-Trust Act, an "Anti-Systemic Risk Act" would dismantle, or at least limit, risks when they become too concentrated.

Creating such an "Anti-Systemic Risk Act" is a tricky thing, however. How do you decide which firm has too much risk? The Sherman Anti-Trust Act works because tests exist to determine whether an enterprise is "bad" for the economy. Such a test led to the 1984 breakup of AT&T, for example. Any potential Anti-Systemic Risk Act needs a test, too.

The secret rests in the concept of "disorderly liquidation." There's a certain point at which the sheer volume of assets being sold into a market precludes liquidation in a normative manner. The Long-Term Capital Management situation in the late 1990s was a prime example of this. LTCM held a massive volume of assets that had greatly depreciated in value after the Russian ruble devalued unexpectedly. Normally, LTCM's financial loss would be the problem of LTCM and its investors. The only snag was that the federal government and Wall Street faced a quandary, too. If all those devalued assets were dumped onto the market, other assets would devalue greatly as well – and that would have precipitated the collapse of several major financial institutions. The good would get dragged down with the bad. (Sound familiar?)

Research we have conducted shows that an entity that holds more than five times the amount of shares or assets traded daily may lead to a disorderly liquidation should it need to offload its holdings quickly. We inferred this by looking at groups of publicly traded equities, which showed price volatility often increased substantially when the ratio of total shares outstanding to average daily trading volume grew too large. One likely reason is that the liquidations of those large positions often ended up collapsing the price of the public shares by creating a supply-demand imbalance.

This phenomenon occurred during the dot-com bust just a few years ago. Many executives and venture-capital investors held vast quantities of dot-com shares, to the point where their holdings dwarfed the volume of publicly traded shares. These dot-com companies had lock-up periods during which the holders of privately held shares could not sell their stakes. When those periods ended – and they always ended at some point – these private shares flooded the market. This "disorderly liquidation" caused many dot-com share prices to eventually plummet – and then a sock-puppet became a legend.

There's an additional wrinkle to this. The mark-to-market accounting required by public companies amplifies the risks associated with liquidation. As market prices for an asset climb, mark-to-market accounting lets an investor in that asset recognize greater paper profits. However, such profits may quickly disappear, or even turn into huge losses, when the owner tries to liquidate the assets. Unfortunately, this change in fortune may not happen for months or even years, depending on when management decides to liquidate (a serious moral hazard in itself). Or, as in AIG's case, it could happen at the worst possible time, when other investors decide to liquidate their own holdings.

So beyond the right to pursue a Sherman-like breakup, the buildup of such holdings can be discouraged by requiring public companies to discount mark-to-market valuations when their holdings of a given asset class exceed the average daily trading volume by too much. For example, a company might be required to take a 50% discount to market prices for asset levels exceeding five times the trading volume, and a 75% discount for asset levels exceeding 10 times the trading volume. Clearly this would create a massive disincentive for public companies to accrue too much of a certain asset class—but then that is the desired effect.

This would have worked at AIG, for example. AIG's balance sheet at the end of 2005 showed that it owned $387 billion of CDS risk, known as net notional exposure. In that year, the International Swaps and Derivatives Association estimated that $20 billion to $30 billion of CDS indices were traded daily. Under the solution we propose, AIG would have been prevented from accumulating CDS exposure beyond $150 billion to $200 billion, or recognize a liability on its balance sheet of $150 billon to $200 billion — possibly sidestepping their eventual government bailout completely.

What is best for economies is that they exhibit healthy asset distribution with risk diffused accordingly – which is exactly why we are bewildered by the federal government's actions since the credit crisis intensified last September. Rather than scramble to pair troubled firms with another company, what the federal government should have done (and the Obama administration could do still) is limit the risks to the economy by diffusing them. Don't mash Merrill Lynch with Bank of America, for example; break Merrill up so that its composite risk is dispersed across the economy and investors. Shares of Merrill Lynch Brokerage, anyone?

To resolve the current predicament, we need a concrete, workable framework for minimizing a buildup in risks that endanger our markets and our economy. By limiting concentrations of asset ownership and preventing "disorderly liquidations," the economy will be better protected and markets will function with greater fluidity. No regulation is foolproof, that is true. Yet, rules guide action, and right now we need to reduce our bloated risk – not to compound it.

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