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Statement of the Shadow Financial Regulatory Committee on
Monitoring Systemic Risk

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In late March, Treasury Secretary Geithner outlined a far-reaching set of changes for the financial regulatory structure in the United States. The administration's plan has three parts: (i) a macro-prudential regulator that would have responsibility for overseeing the entire financial system and identifying places where potential systemic risks might be developing; (ii) a systemic risk regulator, which would have the authority to designate certain financial firms as systemically important; and (iii) an agency with the responsibility for resolving systemically important firms that are in danger of failing, using either a conservatorship or a receivership.

The Shadow Committee believes there could be merit in a macro-prudential supervisory entity (which we will refer to as a systemic risk "monitor") that has authority to monitor the financial system as a whole and identify areas where systemic risks might be developing; we are not addressing the other two elements of Secretary Geithner's plan. This monitoring entity would not have authority to designate systemically significant companies, nor the authority to regulate or resolve them. It would be empowered to engage in only two activities: to collect and analyze data both from other government agencies and from private firms, and to coordinate the overall government response to the implications it derives from this information.

The current regulatory structure is institutionally focused. Its various parts are focused on specific industries or institutions, and no agency has both an overall view of the economy and the information necessary to make a

complete assessment of the systemic risks that might be developing in specific sectors or might be generated by transactions between institutions. The absence of this perspective is evident in the weak performance of the banking regulators in the period leading up to the current financial crisis.

To perform its mission adequately, the monitor would require access to extensive amounts of information that is reported to regulatory agencies, and also to information not now being reported by financial or other firms. It would include both macro information about the economy as a whole, and micro information directly from companies engaged in financial transactions about their portfolio assets and liabilities and about their transactions with others inside and outside the financial system. This would be a formidable undertaking that would probe deeply into the risk-taking activities of financial firms and should be based on a study by the monitor of the pathology of past financial crises.

For example, the current crisis can be traced back in large part to the development of a large market in subprime and Alt-A mortgages, a substantial portion of which was turned into mortgage-backed securities and then into collateralized debt obligations (CDOs). The size of this activity—which now is estimated to consist of 25 million mortgages with an aggregate unpaid principal amount of over \$4 trillion—was not understood at the time. No government agency, and no private group, had a complete picture of the substantial risks that were building up on the balance sheets of the banks and other financial institutions that bought and held these mortgages, including Fannie Mae and Freddie Mac. Better information about what was developing in this market would not have guaranteed that the risks would have been discerned and addressed, but it is certain that no effective remedial steps would have been taken unless the necessary information had been available.

Accordingly, the monitoring agency would have to be given both the mandate and the statutory authority to gather the necessary information from all these sources and the staff to analyze it. Even though confidentiality will be required for much of this information, there will undoubtedly be controversy over both the invasiveness and cost of the reporting required. Nevertheless, some or all of this information should be made available to the public (in some cases only in aggregate form, and in some at the level of the individual firm) as an aid to market discipline and to assist organizations and investors that want to bet against and thus retard the growth of an asset bubble.

A necessary part of the monitoring agency's functions would be the coordination of a response by other regulators to the monitor's findings. Accordingly, the monitoring agency should have the authority to receive reports from other regulators, to require them to take additional actions that the monitor believes might be necessary to curb the development of systemic risk, and to enhance the accountability of specialized regulators.

The Shadow Committee notes, but is not addressing, several possibilities for a monitoring entity that have been advanced. Among them would be the Treasury, the President's Working Group, the Federal Reserve, or an entirely new agency within the Executive Branch.