Part II: From the Basle Accord to Measures to Contain Systemic Risk

INTRODUCTION

ERNST BALTENSPERGER

Systemic risk is a central concern in the regulation of banks and the financial sector. To contain systemic risks has always been a major objective of such regulations. Before we can sensibly discuss how systemic risks can be contained, we need to ask two related questions:

- What is systemic risk? How does it work? We need to know the nature of a problem before we can discuss possible remedies to it.
- What is the practical, empirical importance of the phenomena we are talking about? To show that a problem can logically exist does not yet prove that it presents a practically relevant concern. But only if it does, is it fruitful to invest time and thought in attempts to combat it.

What do we mean by systemic risk? Generally speaking, we are thinking of risks which affect not just individual institutions (parts of a system), but the system as a whole. Thus, we are talking about events which constitute a danger for the efficiency, or even for the stability and functionality, of the entire banking and financial system and, consequently, of the economy at large. There can be little doubt that a breakdown of the financial system will eventually have severe consequences for the real economy. There are two different phenomena which can lead to systemic risk in this general sense:

- One is the existence of correlated, and thus undiversifiable, risks, such as, e.g., interest rate or exchange rate induced valuation or refinancing risks, or business cycle risks (frequently also referred to as «market risk»). In contrast to small, customer-specific risks, these risks typically affect many (or even all) banks at the same time and, consequently, can create problems for the system overall.
- The other phenomenon is contagion, i.e. the presence of mechanisms which spread shocks initially affecting just an individual institution to other institutions and the entire system. Contagion mechanisms can spread and strengthen an initial shock. The basis for contagion mechanisms are interdependencies among institutions. Such interdependencies can be the result of either

- expectations and information effects in a world of incomplete, asymmetric information (about the intrinsic quality of banks and bank assets), leading to revisions of attitudes towards one bank based on observed or perceived problems of another bank («fragility of expectations»), or of
direct linkages between institutions, in particular in the form of interbank credits and deposits, counterparty risks in the derivative business (a major form of interbank business), or of interdependencies in payment systems. Such linkages can cause shocks initially affecting just one particular bank to be spread to other banks and the system overall.

Obviously, such linkages, and systemic aspects of risk in general, can be present within a given country (or banking system), but also internationally. Recently, international contagion and interdependencies have received particular attention (the crises in Southeast Asia being a major source of this concern).

If we want to discuss how systemic risks can be contained through regulatory and supervisory measures, we obviously need first to understand the nature of the problem as well as its practical importance. That means, we need first of all theoretical studies of the different possible mechanisms through which systemic risk can operate and of their consequences. These consequences may be inefficiencies in the operation of the financial system (suboptimal risk allocation, general «underperformance» of the system), or disruption, and even breakdown, of the entire system, with a direct and urgent need to overhaul the system. Additionally, we need empirical analysis of the phenomena under debate. Which types of interdependencies, which channels of contagion are practically relevant? Which not? The two papers presented next are attempts to give answers to selected aspects of this question, for the case of the Swiss banking system.

Lastly, we must discuss the possibilities and limitations of alternative measures aiming at the containment of systemic risk. What is the role of

- Direct regulations, such as capital adequacy requirements?
- Government policies in the form of lending-of-last-resort facilities and similar programs of emergency support?
- Enforced transparency through disclosure and reporting requirements concerning the relevant operations? Disclosure to supervisors and regulators, or disclosure to the general public?
- More pronounced international emphasis of financial supervision (international cooperation)?

These issues will be taken up in the panel discussion concluding the conference.