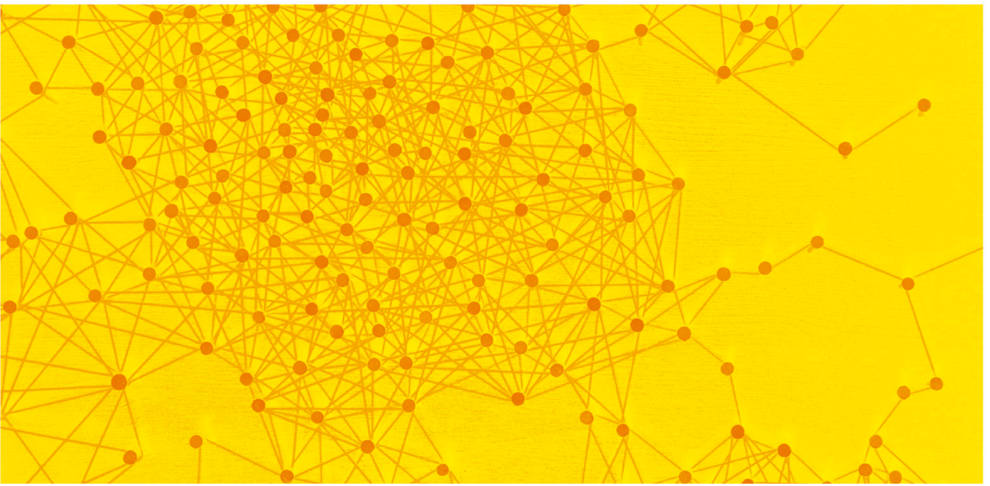

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Systemic Risk

The Myth of Rational Finance and the Crisis of Democracy

campus

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1 Introduction: Systemic Risk Revisited—Steps to an Integrated Approach

Two of the most compelling and intriguing papers on systemic risk have been published, surprisingly, in a law journal. It raises the question: What's law got to do with it? We will touch on this question later in this text and first of all focus on a second perplexing observation. These two seminal papers argue from opposite vantage points, comprehend and conjecture systemic risk in fundamentally different ways, but they contribute in exemplary ways to an enhanced understanding of the problem of systemic risk. The two texts actually lay the groundwork for a more comprehensive understanding of the causes and consequences of systemic risk. The core controversy is exemplified by the following two positions: (1) "Systemic risk is an economic, not a political, definition" (Schwarcz 2008: 204); (2) "Systemic risk must be conceived in terms of political accountability and legitimacy." (Levitin 2011: 438)

These, then, are the crucial research questions: What are the reasons for conceiving systemic risk primarily as an *economic* problem or primarily as a *political* issue? And what are the arguments for an integrated approach which puts a framework of *political economy* center stage in delineating the context for understanding systemic risk? The different approaches, obviously, have serious consequences for the role of law. A predominantly economic approach reduces the role of law to basic premises for acceptable economic behavior, whereas a predominantly political approach calls for a dominant role of politics in safeguarding the common goods involved in financial risk taking. A political economy approach presupposes a more complicated and more sophisticated role of policy and law, at the same time accepting the limits of the regulatory power of law and the limits of the self-organizing capabilities of markets. It may turn out that systemic risk is one more instance of a variety of exceedingly complex and multifaceted societal problems which are testing the limits of democracy and of normative regulation (Ferran and Kern 2011). They

challenge politics and law to develop more complex and responsive governance modes and a cognitive mode of legal authority: "A legally oriented, rule-enforcing regulator is ill-equipped to cope with a systemic crisis caused by a financial system that has outgrown the existing set of rules." (French et al. 2010: 37)

In order to investigate these questions we will—after a short general introduction—first reconstruct a working definition of systemic risk. We will present the economic approach to systemic risk, then the political approach and finally expound our own political economy approach. In the course of our argument we will take advantage of the fact that the global financial crisis of 2007-2009 and the ensuing economic and fiscal crises, including the Euro-crisis, have exhibited stark instances of systemic risk and thus catapulted the topic to high priority on the agendas of major powers such as the United States (US) and the European Union (EU), global actors, institutions and organizations such as the International Monetary Fund (IMF), the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB) or the International Institute of Finance (IIF). We will analyze a few of the most important responses of these actors to the challenge of systemic risk and then focus on two institutional innovations which represent protracted activities of the US and the EU in efforts to improve their capacities to review and handle systemic risk—the creation of systemic risk oversight boards in the US as well as in the EU.

The formation, the proceedings and the operations of these two boards should give us an empirical-practical vantage point in assessing policy responses to systemic risk. Not surprisingly, the global financial crisis and its aftermath have provoked a tsunami of analyses, reports, position papers and a broad spectrum of research of all kinds which, instead of creating more clarity and insight, now threaten to obfuscate the core problem, which is a better understanding of systemic risk as a qualitatively new feature of global finance, as an emergent property of a highly integrated and concatenated global financial system. By adding small case studies of these new institutions which directly respond to an increased awareness of systemic risk, we aim at enriching the necessary conceptual clarifications and contestations with the complexities of real-world policy processes which try to tackle a phenomenon that is quite special insofar as it is mainly constituted and characterized by non-knowledge. Opacity, uncertainty, guesswork, ignorance and surprise are core ingredients of

systemic risks. We are dealing here with variations of the *black swan* category since the global financial crisis in general and its embedded systemic risks in particular carry all the features of highly improbable events that have extreme impacts on entire systems and, surprisingly, seem quite obvious and predictable *after* the fact. However, before the fact systemic risks are subject to the dire logic of *black swan* events, meaning that "what you don't know [is] far more relevant than what you do know" (Taleb 2007: XXIII). Or in the words of the physicist Richard Feynman: "It is not what we know, but what we do not know which we must always address, to avoid major failures, catastrophes and panics." (Feynman, cited by Haldane and Madouros 2012: 2)

Herein lies a complication of analyzing systemic risk which is still almost unnoticed in the debate—the relevance of the distinction between risk and uncertainty as originally outlined by Frank Knight (1965). According to Knight, risk is defined by uncertain outcomes in spite of certainty about the probabilities of different possible future outcomes. In contrast, uncertainty "exists in situations where we not only face variations in future outcomes, but the probabilities associated with possible future outcomes—indeed, possibly even the nature of future outcomes—are not known *ex ante*" (Stout 2012: 1180). Taken seriously, this consequential distinction would force us to speak of *systemic uncertainties* rather than of systemic risk, since *systemic risk* as understood in the broad discussion includes areas of risk and areas of uncertainty. In particular, the possible consequences of major risk propensities of big financial firms for the economy at large and even for political systems by definition are uncertain and not just risky. The acute difficulty of looming systemic *risk* for policy and political decision-making is exactly the fact that "we simply do not know" (Keynes 1937, cited by Stout 2012: 1180) what the implications and impacts of an exploding financial infection might be.

In order to remain comprehensible within the ongoing debate, however, we stick to the dominant usage of the term systemic risk and simply note that we include the element of uncertainty, as our definition will show.

An adequate analysis of systemic risk, we surmise, must be heedful of the special features of its object. The next manifestation of systemic risk will come as unexpected as the previous one. It would be preposterous to assume that a lucid analysis of systemic risk will prevent any future occurrences of systemic risk. What might be achieved by way of analysis,

however, is a more refined understanding of some of the conditions, contextual features, causal relationships as well as operational and functional specifics of constellations which may produce systemic risks. This *caveat* is particularly important with regard to legal scholars (and the law) which are trained to deal with and offer solutions to problems. In the US the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank Act or DFA) of 2010 is a major piece of legislation aiming at rebuilding the legal foundations of a governance regime for the financial system. But of course, this is by no means a solution for the financial crisis since all depends on the specifics of interpretation, implementation and political exploitation. There is no solution to the problem of systemic risk—as there is no solution to the problem of non-knowledge. What can and should be achieved, including a role for law, is to render the problem of systemic risk operational in the sense of establishing a *modus vivendi* in handling and managing a pressing perennial problem.

A pernicious trait of systemic risk lies in the fact that by definition it cannot be restricted to internal transmissions of the financial system. The scariest part of systemic risk is its unpredictable impact on society at large and on the political system in particular. When governments topple because of financial scandals and mismanagement, when simplistic populist policies prevail and threaten to derail sound democratic discourse, when ministers and entire governments are replaced by experts, important policies are decided by central banks instead of parliaments, and when public debt increases to unfathomable amounts, then systemic risk becomes a problem for democracy. "The great challenge is to devise a system to identify risks that threaten market stability before they become a danger to the general public." (Sheila Bair, cited by Johnson 2012: 2)

This is an essential point: Bankruptcy of a financial firm, a local financial crisis or the breakdown of a large investment fund are *normal accidents* and normal events in a competitive financial market characterized by ups and downs and by successes and failures. As long as these volatilities do not impinge on the economy at large (by way of feedback loops and vicious circles, creating an imminent economic crisis, unemployment and public turmoil), and as long as they do not impinge on the political system, these financial crises can strictly be seen as results of market dynamics. *Only when a financial crisis is threatening the political system and thus forces politics to save private firms with public money, the term systemic risk comes into play*. The mother of all questions concerning system risk, therefore, is

the question: Is this financial firm/institution in question too big, too central or too interconnected to fail—and is it thus able to take the political system hostage?

Beginning in 2007 the global financial crisis has had and is still having devastating effects across the globe and in many areas of society. The political fallout of the crisis will continue to be more consequential than financial losses, particularly as long as the worst losses are socialized and turned into public debt and tax payers' liabilities. A wicked chain of events leads from crises of financial institutions and financial systemic risk to economic troubles and downturns which in turn demand political crisis management under conditions of siege which in turn endangers democratic decision-making and the legitimacy of government policies. The public (i.e. the famous 99 percent) sees itself and its political representatives taken hostage by a small minority of reckless gamblers which takes home huge bonuses in good times and asks for unconceivable amounts of public money in bad times. The term *taken hostage* has to be understood literally: Financial institutions have been able to convince politicians that without public bailouts the financial system would crash, then the economy, and then there would be insurmountable problems for politics and government. The red circle in the following figure shows the threatening precipice of falling share prices of major financial firms (green Morgan Stanley, orange Goldman Sachs, blue S&P 500) in September 2008 which, if continued, would bring the financial system to a halt.

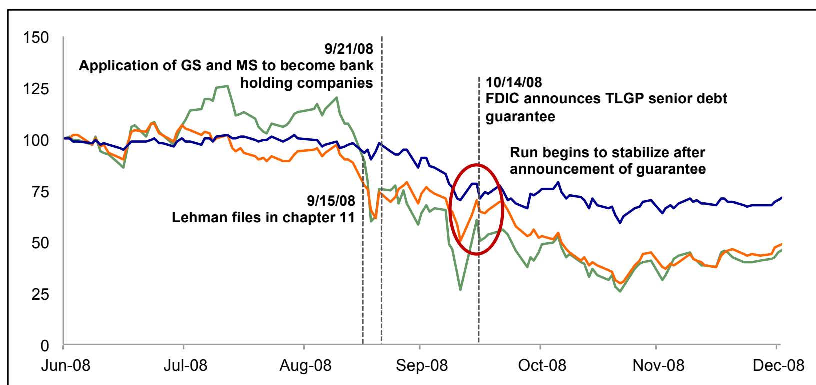

Figure 1: Morgan Stanley and Goldman Sachs — Share Price Evolution.

(Scott 2012: 135)