

Establishing a New Commons

Implementing Macroprudential Regulation: Theory, Governance and Information Needs

13th International Banking Conference
Federal Reserve Bank of Chicago and the
International Monetary Fund

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September 24, 2010

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What does a commons mean in the financial sector?

- Some metaphors
- *From Merriam-Webster online:*
 - *A piece of land for common use, e.g., a pasture or public space in a municipality*
 - *The legal right to take a profit in another's land in common with the owners*
- *From Wikipedia*
 - *A large database, freely usable, to which all can contribute*

Commons in the Financial Sector

- The financial sector historically has had areas of commons.
 - Development of market mechanisms and conventions
 - Elements of shared infrastructure (clearinghouses)
 - Coordination, mutual support during financial (1907) or other stress (e.g., immediately after 9/11).
- These are public goods, although not pure public goods.
- Inherent tension between competitive opportunity and the benefits of the commons.
- Governance for public goods is difficult (e.g., stability of cooperative solutions; free rider problems).

The Erosion of the Historical Commons

- *Extending the metaphor.*
- **The enclosure movement**, the erosion of the commons in Great Britain at the start of the industrial revolution, caused great social and economic turmoil.
- As the traditional information advantages of financial firms (e.g., as market-makers) has eroded, they have sought new ones.
- The new ones include proprietary models, proprietary data, and proprietary risk management systems to manage the rapid growth of complex activities.
- Result: erosion of transparency, elevated risk.
- **A modern version** of an enclosure movement.

Understanding the Need for Commons

- Growing literature on systemic risk helps us understand more about why commons are needed.
 - See, for example, Adrian –Brunnermeier (2008), Adrian/Shin (2010)
 - Two insights relevant to commons
 - How the leveraged nature of financial institutions creates interdependency among them
 - The dependence of individual risk outcomes on the level of systemic risk and the positions of others (COVAR)

Two Areas for Commons and an Issue

- **Financial information.** A firm cannot evaluate its risk without information about the distribution of positions of others.
- **Risk Management.** Risk control failures at one firm can contribute to losses at others.
- **Who's in, who's out.** Only some firms are classic intermediaries, the longtime focus of regulation; but a much wider range of firms today appear relevant to a commons.

How much does the need for commons challenge traditional ideas about firm governance?

- For a firm to evaluate fully its own risk, it needs its own information and information from the market. The issue is how to produce that external information, much of it viewed as proprietary.
 - Could purchase from consultants or vendors, but requires vendor access to the information.
 - The government can impose reporting requirements.

Firm Governance: Information

- Much of the **available external information** is vendor-supplied and sometimes costly;
 - some comes from disclosure or reporting requirements;
 - overall the available information is incomplete;
 - what seems important are streams of quantities and prices, and distributions of positions, not the identification of individual firm positions.
 - Market mechanisms could produce some of these data.

Firm Governance: More on Information

- The analysis to understand interconnections among firms and markets likely is expensive to produce at individual firm level.
- Yet the analysis has value to a wide constituency.
- This requires rethinking how we define public and private information, that is, the boundary of a commons

Another Firm Governance Challenge: Risk Management

- The potential impact on the individual firm of risk-taking by others in the market creates a need for more visibility into the risk management process at firms.
- But creating sufficient transparency or a self-regulatory approach to risk judgments while respecting the essentially internal nature of risk decisions is difficult.
- Supervision of financial institutions can provide some assurance, but the results are confidential and rarely rise to the level of public actions, such as “cease and desist.”
- A substitute discipline is the risk management and standardization of clearinghouses or central counterparties—a new commons.

Re-establishing the Commons: Who Owns? Who Benefits?

- In establishing a commons, need to decide who can “freely use” and “can contribute to” the common.
- Today’s financial landscape seems less dominated by bank and broker/dealers; investor/traders and institutional investors have a lot of “weight”, in terms of risk and activity.
 - Whose information matters?
 - Who benefits from common infrastructure? Who controls it, who pays for it and how?
 - How do cooperative solutions change as the ownership group grows to include investors?

Not a Return to the 1950s/60s

- In the early post-Great Depression financial system, certain features helped sustain the commons
 - Strict limitations on activities and hence the risk profile
 - Large buffers of capital and liquidity
 - Substantial competitive protection
- Ultimately, those features gave way to more intense competition and the globalization of financial activity.

Hence, Need Fresh Approaches to Establishing a Commons

- What constitutes a sufficient set of information for each firm and its supervisors to assess the firm's risk?
Systemic risk?
- What is the role for cooperative solutions to producing that information? What is the role of government?
- How do financial market participants ensure that risk management at firms is adequate?
- What circle of financial firms manages the commons?
- The Dodd-Frank Wall Street Reform and Consumer Protection Act gives us a broad direction.