COMMENT ON PROFESSOR SCHWARCZ'S ARTICLE "CONTROLLING FINANCIAL CHAOS"

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INTRODUCTION

With the devastating impact of the Global Financial Crisis still reverberating around the globe, the Eurozone sinking ever deeper into a sovereign debt and banking crisis, and the developed countries struggling to climb out of the recession trap they have fallen into since 2008, original thinking, like that offered by Professor Steven Schwarcz in his *Wisconsin Law Review* article[1] is very welcome and timely. The academic and policy-making communities share an unusually widespread consensus regarding the causes of the Global Financial Crisis. However, views on the right policies that will restore stability to the global financial system tend to differ sharply. Professor Schwarcz proposes a global liquidity mechanism for the wholesale banking sector, since, in his view, most other measures to contain systemic risk in the global financial system are likely to fail. I find the remedy intellectually elegant and with strong theoretical merits. In principle, building a liquidity provider of the kind suggested by Professor Schwarcz, especially if the source of liquidity could be at least partly privatized (as he proposes[2]), could go a great deal towards averting unnecessary propagation of systemic risks through a liquidity crunch and thus reduce the scope for bank bailouts, which entail intolerable costs to society and the taxpayer. It is also an effective formula to counter the effects of fat tails, which are based on tiny correlations of seemingly uncorrelated risks and thus probably impossible to predict and guard against. In practice, however, such a proposal would have to overcome very difficult political and practical obstacles.

I. ARGUING THE CASE FOR A PRIVATIZED GLOBAL LIQUIDITY SCHEME

Professor Schwarcz notes in his article that "[r]egulation could protect the financial system in at least three ways: by limiting the triggers

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1. Steven L. Schwarcz, *Controlling Financial Chaos: The Power and Limits of Law*, 2012 WIS. L. REV. 815.

2. *Id.* at 829–30.

of systemic risk, by limiting the transmission of systemic shocks, and by attempting to stabilize the system."[3] But as he accurately observes:

> Eliminating the triggers of systemic risk is not feasible. Eliminating the transmission of systemic shocks is likewise not feasible.
>
> It therefore is critical to try to stabilize the financial system against the consequences of systemic shocks. This will involve stabilizing both systemically important financial firms and markets impacted by the shocks . . . .
>
> The first approach—ensuring liquidity—would help to stabilize firms and markets. It also would help to control the motivation of systemically important firms to externalize their costs. If the source of the liquidity could be privatized, public costs would be even further reduced.[4]

In other words, Professor Schwarcz proposes the introduction of a global liquidity provider, whose liquidity sources are, ideally, at least partly privatized. This scheme would inject liquidity in the system in the event of a crisis when all other sources of liquidity to the wholesale banking markets dry up in order to avert turning liquidity shocks into solvency shocks that undermine the stability of the global financial system. The main justification for the mandatory introduction of such a privatized liquidity scheme is, according to Professor Schwarcz, the principle that "regulation should strive not only to maximize economic efficiency within the financial system but also to protect the financial system itself."[5]

Accordingly, in order to build his argument, Professor Schwarcz offers a concise and erudite review of most regulatory techniques, such as increased capital, structural reform, and recovery, and resolution plans (living wills) that are currently introduced and tested to make the financial sector safer.[6] In this respect, Professor Schwarcz highlights the pitfalls of reforms currently under way, including the flawed belief that compensation reform in the banking sector can truly be effective and expresses reservations about the merits of contingent capital instruments.

However, while contingent capital instruments with an early trigger clause could lead to unnecessary panic in financial markets, the mooted

3. *Id*. at 838–39.
4. *Id*. at 839.
5. *Id*.
6. *See id.* at 834–38.

European Union proposals for the introduction of a bail-in mechanism,[7] under which bank creditors bear a considerable amount of the pain caused by bank failures, should be lauded. Extending the pain of bank failures to bondholders and other unprotected bank creditors to the exception of depositors would heighten creditor incentives to monitor bank management behavior strengthening, in the process, a key market discipline mechanism.

In the same manner, Professor Schwarcz's criticism of living wills is perhaps unduly focused on their ex post effect, ignoring their potential ex ante utility. One of the main functions of living wills is to provide regulators ex ante with an accurate picture of the banks' structure and business lines, and to provide early flashpoints for dangerous zones within banks' business models and operations.[8] Equipped with this information, regulators may then order a simplification of labyrinthine corporate structures and the shoring up or closure of vulnerable business lines or subsidiaries.

Professor Schwarcz has clearly thought very deeply about the causes of the global financial crisis. He accurately holds that the systemic risk transmission mechanism relating to circumstances under which liquidity evaporates from the markets, due to a marked lack of liquidity support mechanisms to sustain active markets in structured credit and other wholesale banking markets, was not only among the principal reasons of the global financial crisis,[9] but will also be at the heart of any

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7. *See* European Union Commission Proposal for a Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms and Amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No 1093/2010, COM (2012) 280/3, arts. 37–38, *available at* http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/COM_2012_280_en.pdf.

8. *See* Emilios Avgouleas et al., *Bank Resolution Plans as a Catalyst for Global Financial Reform*, J. FIN. STABILITY (forthcoming), *available at* http://www.sciencedirect.com/science/article/pii/S157230891100060X.

9. The deleterious effect of a generalized liquidity crisis in the wholesale banking markets was also well articulated and documented by Professors Gary B. Gorton and Andrew Metrick, who have argued that the panic of 2007–08 was triggered by a run on the repo market, which was one of the most important short-term lending markets and provided financing for a large number of structured finance activities. Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on the Repo* (Nat'l Bureau of Econ. Research, Working Paper No. w15223, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id =1454939. Repo transactions are mostly collateralized with securitized bonds. Professors Gorton and Metrick suggest that the juncture between repo financing and securitisations was the main trigger of the crisis, since concerns about the liquidity of securitized bonds (used as collateral) led to deeper and deeper haircuts—increasing the amount of collateral required for any given transaction. *Id.* at 1–4. Essentially, with declining asset values and increasing haircuts, the United States banking system became insolvent. *Id.* at 1.

future crisis.[10] Therefore, Professor Schwarcz's article brings the acute problem of lack of liquidity support mechanisms in wholesale banking markets into sharp focus.

Finally, Professor Schwarcz's proposal of a privatized liquidity provider of last resort—which would, in fact, act as market maker of last resort for collateral that has unexpectedly become illiquid—could serve, if properly implemented, two very important roles. First, it would prevent the fast disappearance of liquidity in the wholesale and shadow banking sectors stemming a major systemic risk transmission channel. Secondly, it could lead to internalization of risk associated with reliance on short-term funding, drastically reducing the scope for bank failures and attendant bank bail outs.

II. PRACTICAL OBSTACLES AND OTHER POLICY CONSIDERATIONS

I turn now to the analysis of the political and practical obstacles that Professor Schwarcz's radical idea is bound to face. To begin with, Schwarcz agrees that the continuous role of central banks as liquidity providers of last resort to the formal banking sector shall continue and it would have been insensible not to, even if, in the case of U.S. distressed banks, access to such emergency funding is restricted to failing banks.[11] Furthermore, the new capital and liquidity requirements of the Basel Committee on Banking Supervisor, known as "Basel III,"[12] require banks to hold adequate liquidity reserves to cover most of their short-term and long-term liquidity requirements. Thus, implementation of Professor Schwarcz's proposal would face two possible hurdles: privatizing at least part of the cost of liquidity support and extending that support to unregulated banking markets also known as the "shadow banking sector."[13] To achieve consensus to establish a global privatized liquidity provider for essentially the shadow banking system could be seen as a

10. *See* Schwarcz, *supra* note 1, at 827–28. For the increasing importance of this new risk and the fragility of confidence in wholesale/institutional lending markets, see Jean-Charles Rochet, *Systemic Risk: Changing the Regulatory Perspective*, 6 INT. J. CENT. BANKING 259, 265–69 (2010).

11. *See* Schwarcz, *supra* note 1, at 829 (arguing that "[l]iquidity has traditionally been used, especially by government central banks, to help prevent financial firms from defaulting . . . . Ensuring liquidity to stabilize systemically important firms would follow this pattern, except that the source of the liquidity could at least be partly privatized . . .").

12. *See generally* BASEL COMM. ON BANKING SUPERVISION, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BANKING SYSTEMS (Dec. 2010), *available at* http://www.bis.org/publ/bcbs189_dec2010.pdf.

13. *See generally* ZOLTAN POZSAR ET AL., FED. RESERVE BANK OF N.Y., SHADOW BANKING (Staff Report No. 458, 2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr458.pdf.

step too far in favor of the wholesale financial services industry, which in public consciousness has indelibly, and possibly unfairly, been stigmatized as "casino banking." Thus, such a proposal would possibly face strong political outcry.

Adverse public reaction, in spite of the strong logic of the scheme, would provide ammunition to the regulatory community promoting as superior its already advanced initiatives for battling systemic risk in the financial sector such as derivatives trading and clearing centralization and facilitation of bank resolution. And in this respect one argument cannot be challenged: liquidity provision would and can do nothing to prevent the causes leading to a systemic crisis, something that only a combination of macro-prudential and properly calibrated monetary policies can do. Of course, Professor Schwarcz has already expressed his limited confidence in such measures and his skepticism ought to be heeded.

Furthermore, eventual implementation of Professor Schwarcz's proposal would have to face two additional obstacles. First, the firms that would have to be taxed the most for the proposed liquidity support fund would be those in the unregulated banking sector. But, in the absence of a global registration scheme for shadow banking vehicles, it will remain very hard to identify, control, and tax the key players of the unregulated sector. Second, and admitting that Schwarcz does not insist on full privatization, doubt may be cast on the ability of a private sector fund to provide the vast amounts of liquidity required to support the highly interconnected global banking system, in the event of a global crisis similar to that of 2007–09. In order to avert any fears that the fund would eventually run out of money and liquidity and global markets would dry up, worsening instead of stemming panic, even a fully privatized scheme would inevitably have to maintain open credit lines with the world's biggest central banks. Open credit lines between the proposed privatized global liquidity fund and big central banks would return at least some of the ultimate onus for the provision of liquidity to the global banking system to central banks, and indirectly to the taxpayer. Although central banks can create, in the short run, money and liquidity without having to have recourse to the taxpayer for recapitalization purposes, such arrangements would eventually reduce the private nature of the proposed liquidity scheme.

Finally, systematizing liquidity provision to the shadow banking sector could in itself reinforce rather than curb moral hazard. Knowledge that in one way or another a global scheme would be available to provide liquidity against collateral, even at deep discount, could lead to unacceptable narrowing down of spreads and inadequate posting of collateral, making the global banking system more rather than less fragile in the event of bankruptcy. One way to avert this danger is to have a global regulatory authority that would determine the size of haircuts taken by market players for collateral used in shadow banking operations attached to the proposed global liquidity fund. That might be considered as an important supplement to the system proposed by Professor Schwarcz.

CONCLUSION

In conclusion, my view is that systematization and privatization of liquidity provision to the wholesale global banking market is a brilliantly elegant idea whose implementation would probably prove very difficult, as it would have to overcome a host of possibly insurmountable political, regulatory, and practical obstacles. This takes nothing from the force of Professor Schwarcz's argument that banking regulation reforms will be successful only if they become global in their approach and reach. Fragmentary approaches to regulation of the global financial system are bound to see their effectiveness undermined, in spite of the expectations currently attached to them.[14] Finally, Professor Schwarcz's important analysis of the systemic effects of liquidity failures in certain asset markets ought to be carefully studied and his views about the causes of such failures particularly heeded.

14. For a radical model, see EMILIOS AVGOULEAS, GOVERNANCE OF GLOBAL FINANCIAL MARKETS: THE LAW, THE ECONOMICS, THE POLITICS (2012).