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March 2011

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Systemic risk

As the federal government tries to manage systemic risk, I wonder why no one is asking the question that should be addressed first. Can systemic risk be managed? When the Financial Stability Oversight Council (FSOC) was created by Dodd-Frank, it sought to identify organizations (companies, funds) that could put the financial system in jeopardy as had happened in 2008. Not surprisingly, since it was created by politicians, it did not seek to address the systemic risks created by the government.

In the past, regulatory oversight and political agendas have contributed to systemic risk and often been the leading indicator. Stories abound about the lack of accountability by both regulators and elected officials. Many times regulators were naïve to risks, but at times they have identified the threat and been turned away when they asked for resources. Here are some instances (not exhaustive) when government played a pivotal role in creating systemic risk.

- Home mortgages. Both political parties expressed a desire to increase the percentage of home ownership in the United States. Unfortunately no guidance was given about how to accomplish this goal so incentives were created to put people in homes they could not afford in the long term. Some never made a single payment on their mortgage and others fell trap to rates that jumped after the teaser rates expired.

- Government sponsored entities. By creating firms with an implied advantage over private companies, Fannie Mae and Freddie Mac were able to spend more money on lobbying to maintain their advantages. Their balance sheets exploded and no regulator was strong enough to overcome the lobbying pressure exerted on them.

These types of outcomes do not start out as part of a plan. Unintended consequences abound. Risks interact in unexpected ways.

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