We're All in This Together

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Luca Enriques, Alessandro Romano & Thom Wetzer, *Network-Sensitive Financial Regulation*, 45 **J. Corp. L.** __ (forthcoming, 2020), available at SSRN.

It is difficult to know what wisdom from pre-pandemic times will carry forward. One thing that feels very relevant, however, is the notion of applying network-sensitive approaches to regulatory structures that previously were atomistic in orientation. COVID-19 (the global emergency, not the virus) is nothing if not the product of global networks.

It takes some time for the full impact of a new paradigm to be realized. Those of us who have followed the systemic risk literature over the last decade or more will, I think, recognize in "Network-Sensitive Financial Regulation" a more comprehensive embrace of network theory than we have seen so far. Post-crisis recognition of systemically important financial institutions, or SIFIs, has always been somewhat awkwardly bolted onto existing regulatory structures. This is an exceptional article, because it represents a genuine step change in our thinking. It convincingly demonstrates how we might better incorporate network awareness into systemic risk analysis and macroprudential regulation, and then extends its insights further, to the micro level of corporate governance.

Our understanding of how networks operate in financial systems is relatively new. In modelling the financial crisis that started in 2007/2008, we learned a great deal about how risk was transmitted from one institution to another, and how in some cases it ramified into full-fledged systemic risk. With the benefit of hindsight we also recognized the moral hazard that had flowed from certain financial institutions being too big, or too interconnected, to fail: they had to be bailed out for the sake of systemic stability, but that meant that directors, officers, and shareholders of TBTF/TICTF firms were relatively immune to the downsides of the firm's excessive risk-taking.

"Network Sensitive Financial Regulation" is a mature and compellingly-argued outgrowth of those experiences. Luca Enriques', Alessandro Romano 's, and Thom Wetzer's key argument is that "the transition to a regulatory regime that can effectively mitigate systemic risk in the modern highly connected economy will not be complete until financial regulation fully accounts for the structure of the financial network and the interconnections between its components" (P. 4.) Moreover, because of the torque that a firm's systemic significance can have on normal corporate governance assumptions, network theory also has a contribution to make in the governance domain.

The authors provide a brief and useful history of how financial regulation progressed from the atomistic microprudential concerns of the pre-crisis era, which generated collective action problems and procyclicality, to the macroprudential concerns that governed especially SIFI regulation post-crisis. This much is familiar. From there, in a fresh move, the authors point out that a good deal of post-crisis macroprudential regulation – such as SIFI designations based on a financial institution's asset size, whether $50bn or $250bn – still operates in a basically atomistic way. (It makes matters worse if regulation is based on binary SIFI/non-SIFI thresholds and bright lines, rather than institution-specific risk assessments.) Sometimes, the atomism is a function of how regulations are written. At other times, potentially network-sensitive methods nevertheless end up being operationalized atomistically.

Consider, for example, interconnectedness. Enriques et al. describe the fundamental concepts underlying network theory, such as nodes and centrality. In crude terms, the more central a financial institution is to a network, the greater its capacity to cause systemic harm. The authors also describe the ways in which different network typologies – mainly, more highly interconnected or looser ones – respond to larger and smaller shocks in different ways. By factoring in data about a firm's centrality and the typology of the network it operates within, regulators could be in a position to calibrate, more directly, firms' regulatory obligations to the systemic risk they present.

Instead, firm interconnectedness is commonly evaluated based only on the sum of a firm's relevant exposures, as if those exposures had the same consequences regardless of the firm's location within a network, or the network's characteristics. Activity-based SIFI designations for non-banks, while an improvement on entity-based size thresholds, would also seem to fall into this category. These kinds of suboptimal implementation highlight the degree to which, even post-crisis, we have still not fully taken on board the value of network-level analysis.

One of the authors' most provocative claims, however, is that just as macroprudential regulation can be made more effective through network-sensitive adaptations, so too can microprudential regulation – that is, corporate governance. Enriques et al. reject the idea that corporate governance rules, including the shareholder primacy norm, are atomistic by definition. When it comes to SIFIs in particular, corporate governance rules incentivize greater risk-taking, and growing the firm to become too big to fail (thereby enjoying a lower cost of financing and externalizing downside risks). In other words, the fact that a firm is systemically significant alters the incentives that would otherwise operate. This is, again, why the firm's position within a network, and the network's typology, matter. The authors illustrate this point by demonstrating how other new and interesting proposals around SIFI corporate governance – John Armour and Robert Gordon's on directors' and officers' personal liability, Lucian Bebchuk and Holger Spamann's on executive compensation, and Yair Listokin and Inho Mun's on shareholder rights in shadow resolutions – can all be made more context-sensitive, more finely calibrated, and more effective by introducing meaningful network-level data about the firm's position.

"Network-Sensitive Financial Regulation" reflects an important shift in the unit of analysis, from individual firm to network. It is because the authors

have fully absorbed the importance of networks in financial systems that they are able to then roll those insights back to the governance context.

Networks may in fact be the concern of our age. Like internet hive mind rumors, like the pandemic, systemic risk indicators bring home how profoundly the health of our institutions depend on understanding the relationships between them. We were never islands, but nor have we ever been so interconnected. The time is ripe for the kind of paradigm shift that Enriques et al. propose here, in the context of financial regulation and corporate governance.

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