STRUCTURAL REFORM OF SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS: THE FSB's RESPONSE TO TOO BIG TO FAIL

Background

The agenda of financial reform contains proposals directed at banks' structure as well as at their leverage and balance sheets, their risk management, and their internal governance. Under the first heading large, diversified financial institutions have been singled out for special attention owing to the damage which failures of such institutions are capable of causing not only throughout the financial sector but also to economies as a whole. Fears of such damage motivated many of the costly bank bail-outs by governments in the United States and Western Europe since the beginning of the financial crisis.

Historically policies towards financial conglomerates have varied for different countries. A well known example of such policies is the United States Banking Act of 1933 (better known as the Glass-Steagall Act). This Act mandated the separation of commercial banking and securities activities through the following provisions: (1) banks were permitted to act as agents or brokers for their customers but were prohibited from underwriting corporate debt or equity securities or from trading equities for their own account; (2) securities firms were prohibited from the business of deposit taking; (3) statutory limits were imposed on banks' affiliation with entities engaged primarily in securities business; and (4) management interlocks between commercial banks and securities firms were prohibited. This Act was finally repealed by the Gram-Leach-Bliley Act of 1999 which allowed the creation of financial holding companies where all types of financial services could be performed subject to rules as to the location of different activities within the corporate structure of the companies.

Such legal separation of commercial banking and securities activities has not existed in most other developed countries. Integration of both categories of activity within single institutions elsewhere is associated with appropriately adapted supervisory standards.

Since the early 1990s the management and supervision of financial conglomerates has become a subject of international regulatory cooperation. This was originally a response to the increased importance of groups of companies under common control whose activities included at least two of banking, securities business and insurance. Recommendations resulting from this work covered a number of issues such as the overall approach to supervision, capital adequacy, intra-group exposures and contagion, large exposures at group level, conflicts of interest, fit-and-proper tests for managers, transparency, and supervisory arbitrage. The objective of the recommendations was the development of a regulatory framework which would facilitate cooperation between jurisdictions with different policy histories regarding financial conglomerates.

Until the outbreak of the financial crisis this work on the regulation and supervision of financial conglomerates was able to progress in the absence of major pressures resulting from the actual or threatened failures of financial conglomerates. However, the situation has changed since 2007, and the design of policy towards financial conglomerates has now been largely subsumed under that for systemically important financial institutions (SIFIs) – those in common parlance Too Big to Fail.

Earlier this summer, on the front of regulatory reform, the principal focus of attention was the progress through the United States Congress of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Amongst the issues widely debated during the deliberations leading to this Act was how to address risks posed by SIFIs. During the same period the Financial Stability Board (FSB) issued a less widely noticed document also addressing policy towards SIFIs. This set out a framework that is broadly consistent with the provisions of the Dodd-Frank Act but could eventually justify measures more comprehensive than those contained in the Act (FSB, 2010).

Various provisions eventually included in the Dodd-Frank Act target SIFIs. A newly established Financial Stability Oversight Council can now authorise the Federal Reserve to set more stringent prudential standards for large, interconnected financial firms. These standards comprise capital requirements and leverage limits, risk management and stress tests, plans for resolution in the event of serious financial distress or insolvency, and limits on credit exposure to unaffiliated companies. Other structural provisions of the Act relevant in this context are the Volcker Rule and the Lincoln Provision.

Subject to certain exceptions the Volcker Rule prohibits banks from proprietary trading (i.e. trading for one's own account in securities or derivatives) and from investing in or sponsoring a hedge or private equity fund. Exceptions to the prohibition on proprietary trading can be authorised subject to supplementary capital requirements and quantitative limits. The Lincoln Provision, also referred to as the "spin out" or "push out" provision, limits the ability of banks to act as OTC derivatives dealers. The limit takes the form of a prohibition of Federal assistance (in the form of access to Federal Reserve lending facilities and reliance on deposit insurance from the Federal Deposit Insurance Corporation) to swaps entities. The limit does not apply to entities whose swap activities are appropriately related to their transactions in cash markets.

For those who believe that essential to banking reform are measures restricting both the size and the range of the different activities of large complex financial firms, the provisions of the Dodd-Frank Act fall short of what is required to reduce systemic banking risks and to re-establish a healthier, less concentrated banking sector. Skeptics concerning the likely effectiveness of the Act also point to its gradual phasing-in of the restrictions prescribed and to the way in which it leaves decisions on parts of the final form of these restrictions to regulators' discretion, thus providing further scope for the influence of bank lobbying.

The proposed framework of the FSB

The document of the FSB responds to a mandate of the G20 Pittsburgh meeting to propose measures to address the problems of Too Big to Fail associated with SIFIs. The mandate acknowledges that the strengthening of the Basel capital and liquidity framework and other measures currently envisaged to improve the resilience of the financial system do not explicitly address the risks of moral hazard due to the perception that certain firms are too big or too interconnected to fail. The basic objectives of the FSB's proposed framework in response to this mandate are as follows: (1) to improve the capacity to resolve SIFIs in financial distress or insolvency, while minimising the costs to taxpayers; (2) to reduce the probability of SIFI failures and their impact if they occur none the less; and (3) to strengthen the infrastructure of financial markets to reduce the risk of the spreading of contagion as a result of weaknesses of this infrastructure.

The framework will build on the following principles:

- all jurisdictions should have in place a policy framework targeting moral-hazard risks associated with SIFIs;
- all jurisdictions should have policy tools which enable the resolution of financial firms without systemic disruptions or taxpayer losses;
- all jurisdictions should have the capacity to impose prudential requirements and other structural changes on financial firms commensurate with their systemic importance;
- all national supervisory authorities should have powers to apply differentiated supervision requirements on financial firms according to the systemic risk which they pose;
- all jurisdictions should strengthen or put in place core financial infrastructures which meet standards of robustness assuring systemic stability; and

- FSB member countries will establish a peer-review process for the promotion of national policies to reduce the cross-border risks associated with SIFIs.

The proposals on resolution tools concern both measures at national level and their complement in a global financial system, namely rules for cross-border insolvencies. The national measures mentioned in the FSB document are a standard recipe which includes tools for burden sharing in the event of insolvency, arrangements for temporary financing, and powers to restructure failing banks' liabilities. Rules for cross-border insolvencies will be more difficult to achieve, since a. comprehensive solution would require agreement on the cross-border distribution of losses and on international reconciliation of national insolvency rules. Efforts to achieve such an agreement have a long history but the prospects for their success are still uncertain.

The targets of the proposed measures to strengthen core infrastructures for financial markets are payments systems, systems for securities settlement, and exposures to derivatives. The main measure currently on the table for reducing risks due to derivatives exposures would shift most derivatives to central counterparties (CCPs). These interpose themselves between buyers and sellers of derivatives, assuming the contractual rights and obligations of both parties. The benefits of CCPs are (1) the reduction in the likelihood of domino or knock-on effects of the failure of a single counterparty thanks to appropriately designed financial arrangements for sharing the costs of such defaults among clearing members and (2) increased transparency resulting from the CCP's records of transactions.

CCPs require contracts to be standardised in order to enable the clearance of trades and reduction of clearing members' risk exposures through the multilateral netting of contracts. CCPs can also serve as the clearinghouses for exchanges. Exchange trading can increase the liquidity of the markets for derivatives, thus facilitating both holders' management of their derivatives positions, while also further enhancing transparency. However, even for standardised derivative contracts, a successful shift to exchange trading depends on the existence of sufficient trading interest to ensure an active market.

More effective supervision of SIFIs is unlikely to prove contentious in principle. The measures mentioned in the FSB document include strengthening the effectiveness of boards of directors and of supervisors in their oversight of firms' risk management (with special emphasis on that required for new financial products and for quantitative models) and improved cooperation between supervisors in the home and host countries of financial institutions. Problems under the heading of effective supervision are not achieving agreement on what is required but ensuring its implementation.

More opposition from the financial sector can be expected to the introduction of supplementary prudential requirements and other changes in legal and organisational structures for SIFIs. The language in the FSB document is as follows: "National authorities should have the capacity to impose more stringent requirements on financial firms that due to their size, complexity or interconnectedness contribute to the build-up of systemic risk, give rise to greater negative externalities in case of resolution and remain more difficult to resolve. Such measures should be commensurate with the level of systemic risk posed by the firms and be designed to (i) significantly reduce the probability of their failure by strengthening their resilience and loss absorbing capacity; (ii) reduce the negative externalities that could arise from their failure; and (iii) improve their resolvability and ensure that essential functions for the financial system and broader economy can be continued should the firm fail".

The options mentioned under the heading of supplementary prudential requirements for SIFIs are surcharges linked to firms' capital or liquidity and limits on large counterparty exposures (that would be additional to charges for the exposures in question under the new Basel rules for minimum regulatory capital). Structural constraints include (i) reducing intra-group connectivity through intra-group exposure limits; (ii) separation of particular financial activities within a group's legal and organisational structure, including requirements for "separate incorporate incorporation and stand-alone capacity" for systemically important operations (steps considered during debate on the Dodd-Frank Act which survive in the powers accorded to the Financial Stability Oversight Council, the Volcker Rule and the Lincoln Provision); and (iii) simplification of structures to align them more closely with applicable regulatory and resolution frameworks. Also mentioned under the heading of constraining systemic risks are levies targeting activities contributing to systemic risk.

The FSB document acknowledges the case for national discretion regarding supplementary prudential requirements and legally mandated structural changes for financial firms. This discretion should accommodate the likely variation in the conditions and risks in different jurisdictions. Nevertheless, "given the nature of the risks posed by SIFIs, prudential requirements should be subject to floors or minimums". Moreover "authorities will have to consider the impact that the measures may have across home and host jurisdictions".

Designing a systemic capital surcharge

Preparation of the ground for more detailed proposals is under way. The FSB, IMF, and Bank for International Settlements (BIS) have reported to the G20 Finance Ministers and Central Bank Governors on ways to assess the systemic importance of financial institutions, markets and Instruments (FSB, IMF, and BIS, 2009).In this report a systemic event is defined a disruption to the flow of financial services caused by an impairment of all or parts of the financial system with the potential for having serious negative consequences for the real economy.

Key criteria according to the report for identifying an institution or market capable of causing such an impairment are large size, lack of substitutability (reflecting the difficulty for other components of the financial system to provide the same or similar services in the event of a failure), and interconnectedness (i.e. the direct and indirect linkages between components of the financial system through which individual failures or malfunctions are capable of having systemic repercussions). In its review of key factors meriting special attention in assessments of systemic risk the report draws special attention to leverage (which measures vulnerability of institutions' long and short balance-sheet positions in relation to cushions of financial safety such as equity), liquidity risks and maturity mismatches between assets and liabilities, and institutions' complexity of an institution (reflected in the diversity of their activities and number of their legal entities, centralisation of their management of capital and liquidity, and exposures to new, complex and insufficiently tested financial products).

Research under way on possible design of a capital charge for systemic risk is reviewed in the April issue of the IMF's *Global Financial Stability Report* (IMF, 2010). Two approaches are the subject of special attention in the IMF's review, a standardised approach and a risk-budgeting approach. Under the standardised approach systemic risk ratings are assigned to banks on the basis of estimates of the amount of system-wide capital impairment which their default would impose on the financial system. The rating and thus the capital surcharge would be based on the highest systemic rating assigned to a bank over the cycle - and thus would not vary over the cycle. Illustrative capital surcharges for a hypothetical sector of six banks in two countries would be 4 per cent of risk-weighted assets for institutions deemed most systemic and 2 per cent for institutions deemed as carrying a lower but still significant level of systemic risk.

In the more refined risk-budgeting approach an institution's marginal contribution to systemic risk is determined by its probability of default and its incremental credit value-at-risk. The latter is defined as the worst increase in losses throughout the system which, at a specified level of probability or confidence, might be incurred over a target time horizon owing to the institution's default on its interbank obligations (the interbank market being the location where the symptoms of many financial crises including the current one are first manifest). Estimated surcharges again for a hypothetical sector of six banks in two countries have a calibration more sensitive to varying risk levels and with a lower maximum surcharge than those of the standardised approach. However, the surcharges under the risk-budgeting approach vary procyclically, and the approach's reliance on more sophisticated financial modelling could prove an argument in favour of the standardised approach in the present climate of opinion about such models.

A systemic surcharge and structural reforms

What difference might such systemic surcharges make to banks' minimum regulatory capital requirements ? This would depend on whether the surcharge took the form of additions to the ratio of Tier 1 capital to assets or to the ratio as defined in the Basel rules of all the categories of capital included in total capital to risk-weighted assets. Tier 1 capital consists of equity, retained earnings and a limited number other loss-absorbing instruments. The range of qualifying instruments which can be included in total capital is broader – and thus less demanding. At the time of writing a definitive list of instruments qualifying as capital under the two headings has yet to be decided. The ratio from *The Banker* used for illustration here is the BIS ratio, i.e. the ratio of total capital to risk-weighted assets as defined in the 2006 version of Basel 2 (risk-weightings on assets being estimated by *The Banker* on a scale from 0 per cent to 100 per cent according to the guidelines of Basel 2) (The Banker, 2010). *The Banker* also provides figures for the capital or leverage ratio, i.e. the ratio of Tier 1 capital to total assets. Basel 3 will e eventually include a leverage ratio based on similar principles. However, since the new regulatory leverage ratio is still at the design stage, this capital or leverage ratio is not included in the illustrations below.

Key capital ratios of the new Basel 3 are the following: a ratio of total capital to risk-weighted assets of 10.5 per cent (to be phased in by 2019 according to the schedule of the Basel Committee on Banking Supervision but likely in practice to be introduced earlier owing to pressures from financial markets and the greater promptness with which the new rules are introduced at national level); and a countercyclical buffer consisting of a ratio of equity plus fully absorbing capital to risk-weighted assets in a range with a ceiling of 2.5 per cent, the precise figure being left to national discretion (Basel Committee on Banking Supervision, 2010). Thus the systemic surcharge (which according to the discussion above may consist of capital in the range of 2-4 per cent of risk-weighted assets) would be added to a BIS ratio of 12-13 per cent.

The figures which follow are intended to give only a rough idea of the possible incidence of a systemic capital charge for limited samples of banks in selected countries. For the purpose of this illustration banks have been included on the basis of their size as measured by the value of their assets in 2009 (not including off-balance-sheet positions). The threshold value of assets of the banks included is USD 100 billion for developed countries and USD 50 billion for emerging-market countries. This choice may mean that some institutions of systemic importance – for example, due to their interconnectedness - to which national authorities may apply the capital surcharge have been omitted. A level of 12.5 per cent for the BIS ratio was chosen as a benchmark to indicate the number of banks which in current conditions would be more likely to be forced to raise new capital or to adjust their balance sheets in response to the imposition of a systemic capital surcharge. In a few of the countries specified some banks with assets above the threshold have not been included owing to the non-availability of figures for their BIS ratios in the survey of *The Banker*.

- France: the range of BIS ratios for 4 banks was from 10.9 to 14.2 per cent; 2 of these banks had BIS ratios below 12.5 per cent.
- Germany: the range of BIS ratios for 15 banks was from 9.2 to 21.2 per cent; 5 of these banks had BIS ratios below 12.5 per cent.
- Japan: the range of BIS ratios for 15 banks was from 8.35 to 22.56 per cent; 9 of these banks had a BIS ratio below 12.5 per cent.
- Switzerland: the range of BIS ratios for 5 banks was from 14.1 to 20.5 per cent.

- United Kingdom: the range of BIS ratios for 6 banks was from 12.4 to 17.6 per cent; 1 of these banks had a BIS ratio below 12.5 per cent.
- United States: the range of BIS ratios for 19 banks was from 11.92 to 19.15 per cent; 1 of these banks had a BIS ratio below 12.5 per cent.
- Brazil: the range of BIS ratios for 4 banks was from 13.71 to 25.6 per cent.
- China: the range of BIS ratios for 16 banks was from 8.88 to 14.35 per cent; 15 of these banks had BIS ratios below 12.5.
- India: the range for 3 banks was from 12.9 to 14.73 per cent.
- Russia: the range of BIS ratios for 3 banks was from 15.6 to 20.7 per cent.
- South Africa: the range of BIS ratios for 4 banks was from 14.57 to 15.6 per cent.

These figures suggest that a systemic capital surcharge might result in at most limited additional costs for a substantial proportion of SIFIs and thus entail at most limited incentives to downscale their size or to shed activities. Thus the figures may imply the need for greater recourse by national authorities to the structural measures listed in the FSB document, namely the requirement of separation - including separate incorporation – of specified activities, intra-group exposure limits, mandatory simplification of financial conglomerates' structures, and levies targeting particular activities.

Changes designed to simplify the structure of financial conglomerates (which SIFIs are) or to limit the range of activities in which they can engage are likely to be strongly resisted by the banks. In London suggestions that reform might include such measures have produced rumblings from this quarter about possible moves to other jurisdictions. Such threats underline the importance of coordinated action on measures for the structural reform of large, complex financial institutions on the part of FSB member countries. The limits of reliance on the adjustment of capital levels as an instrument for achieving the objectives of the agenda of financial reform in this point to the way in which the strengthening of traditional prudential rules must be complemented by structural measures if the reform is to be successful in reducing the frequency and severity of future financial crises. Effective reform requires the adoption of mutually reinforcing measures as a package.

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