

**POSSIBLE WAYS TO CONTAIN SYSTEMIC RISK
IN RESPECT OF SYSTEMIC FINANCIAL INSTITUTIONS**

- Discussion Paper -

Introduction

The idea of imposing a premium on Systemic Financial Institutions (SFIs) arose in the USA where smaller banks are remarking that they are having a hard time competing for deposits because of a perception that some financial institutions are too big to fail while the smaller banks are not. It would seem that it is mainly for this reason that many of the legislative proposals currently being debated in the US envisage to impose more onerous burdens on banks as they increase in size.

The context of the debate is utterly different in the EU where competition authorities are taking action (on the basis of state aids powers) to re-establish a level playing field between banks that have received government support and those that have not. This is not happening in the US.

The EBF has welcomed the Commission proposals to move forward towards a more efficient and integrated European supervisory system, incl. the introduction of the European Supervisory Risk Board, which will take care of systemic risks by means of early warning calls that contribute to keeping financial stability.

Nevertheless, there seems to be a consensus among politicians and some policy-makers that initiatives need to be taken to limit public intervention in the financial sector as much as possible and minimise the fiscal burden of rescue operations undertaken by governments. The EBF agrees that ways need to be found to limit public intervention in stressed situations.

Various types of policy responses are currently being discussed to limit public intervention. They can be summarised as follows:

- (i) Systemically Important Financial Institutions (SIFIs) should be obliged to down-size the range of activities to make sure that they will be less likely to put deposits at risk in the future (“narrow banking”);
- (ii) The probability of SIFIs failing should be reduced by requiring them to internalise the costs that a government bailout would impose on taxpayers by paying a premium;
- (iii) Measures need to be developed to contain the (exogenous) risk exposures of SIFIs by reducing the level of interconnectedness within the system;
- (iv) Conditions need to be created which facilitate an orderly unwinding of banks’ cross-border activities if difficulties arise.

The objective of the current discussion paper is to examine the relevance of those proposed approaches.

Before entering into this debate, it may be useful, however, to emphasise that a debate on SIFIs needs to be put in a wider perspective.

- The most important lesson learned from the financial crisis was indeed that the primary focus of banking supervision should be on maintaining financial stability and, in particular, containing systemic risk. Crisis intervention measures adopted by governments (Northern Rock, Bear Stearns, etc) have amply demonstrated that systemic risk is not necessarily linked to the size of financial institutions. Addressing key vulnerabilities within the financial system requires in any event adopting an holistic view on financial stability– which implies that more needs to be done than merely making financial institutions subject to a closer scrutiny. In addition, markets, market infrastructures and other systems which are systemically relevant need to be reviewed from a financial stability point of view and re-organised.
- Since the crisis emerged, banks have taken initiatives to effectively reduce and control risk and, more particularly, strengthened their capital base, reduced their risk exposures in a substantial way. Furthermore, banking regulators have taken a wide range of initiatives to strengthen capital and liquidity requirements which, moreover, now need to be tested under extreme stress scenarios. On top of that, they have taken steps aiming at reducing risk in the system (e.g. introduction of central counterparties for OTC derivatives trading, remuneration principles designed to align compensation to a firm’s risk profile, etc.).

Clearly, therefore, the initiatives which are being examined below are part of a more comprehensive picture which should not be overlooked.

1) Premium on SIFIs

Against the backdrop of the emphasis which is being put today on systemic risk and, more generally, on the macro-prudential dimension of banking supervision, some have suggested that “Systemically Important Financial Institutions” (SIFIs) be made subject to specific constraints. One possibility to achieve this might be to impose higher capital requirements on SIFIs as this would make them more resilient to stress events. Another possibility would be to make SIFIs subject to more intensive supervision and/or additional liquidity requirements.

To focus the debate, it is important to note that the recent crisis clearly demonstrated that distinguishing between SIFIs and other financial institutions is not relevant from a micro-prudential point of view because (i) even relatively small institutions can put the stability of the global financial system at risk (because of the domino effect resulting from interconnectedness), and (ii) vast, empirical literature demonstrates an inverse relationship between size and the probability of a financial institution defaulting as greater size allows for greater portfolio diversification and more investment in risk management.

Furthermore, the idea of imposing a premium on SIFIs is particularly being debated in the US where smaller banks are complaining that they are having a hard time competing for deposits because of a perception that SIFIs are “too big to be allowed to fail” while the smaller banks are not. It would seem that it is mainly for this reason that many of the legislative proposals currently being debated in the US envisage to impose more onerous burdens on banks as they increase in size. The context of the debate is utterly different in the EU where competition authorities are taking action to re-establish a level playing field between banks that have received government support and those that have not. It needs to be recalled, finally, that the EU has always refused to introduce into EU banking legislation a two-tier structure under which large banks would be made subject to different rules.

Therefore, a debate which is focused on size is likely to result in actions which are not desirable from an economic point of view as, within a global world, only large banks which are active across borders are in a position to meet the needs of multinational companies in an efficient way.

It needs to be observed, moreover, that the suggestion to impose a premium on SIFIs apparently takes as a point of departure that the debate surrounding SIFIs primarily has to do with containing endogenous systemic risk – i.e. risk stemming from causes which are internal to institutions and which may propagate through contagion and which, therefore, need to be dealt with by means of micro-prudential regulation and supervision. This ignores, however, that the crux of the issue might be to contain exogenous systemic risk – which is generated by macro-imbalances and international interconnectedness and which is expected to be addressed in the future by means of macro-prudential supervision. Imposing higher capital requirements may be suitable to contain the impact of future endogenous systemic risk events as a larger capital stock allows institutions to absorb the negative effects of endogenous risk. However, additional capital does not provide any protection whatsoever against exogenous risk.

2) **The relevance of Interconnectedness**

Against this backdrop, it can be argued that it is not the size of individual institutions that should be of concern but, instead, today’s high level of interconnectedness within the system. Interconnectedness has rapidly increased with the acceleration of financial innovation and the explosion of financial proprietary trading.

The industry strongly believes that mitigating interconnectedness should be given more attention as a means to reduce systemic risk, which implies addressing issues such as:

- The sophistication and opacity of financial instruments traded in unorganised and unregulated markets, which prevent supervisory authorities from tracing the risks and mapping the interconnections. Measures should be aimed at improving transparency and, more particularly, allowing authorities to collect more information to enable them to monitor systemic risk;
- Improving market infrastructures (creation of clearing systems for CDS - increase the number of settlement finality cycles of large-value payment infrastructures);
- Containing concentration risk and contagion risk;

- Collateral management.

It may be useful to remind in that context that the industry has developed some initiatives to contain systemic risk exposures (such as the introduction of central counterparties in the CDS area, and similar existing arrangements in the foreign-exchange market) and that regulatory proposals have been tabled to reduce counterparty risk.

Moreover, an industry Working Group is examining possible ways to mitigate interconnectedness.

3) **Narrow Banking**

The idea behind the concept of “Narrow Banking” is that the range of activities in which deposit-taking institutions are allowed to engage should be restricted to make sure that banks have no difficulty whatsoever to return the deposits that they have collected from depositors.

Narrow banking covers a whole range of proposals. Some academics have even taken the view that banks should only be authorised to perform a basic public utility function consisting in collecting deposits from the public and providing payment systems to depositors. As a consequence, they would not even be allowed to engage in lending activities. Other academics would be more tolerant and be prepared to accept that banks should be entitled to engage into a (narrow) range of lending activities (mortgage loans; consumer lending; businesses lending). Such proposals are extreme as they put into question the very function which is traditionally conferred to banks and which consists of transforming short-term deposits into long-term loans. On this ground, we do not believe the narrow banking arguments to be realistic.

Basically, the debate on narrow banking focuses on whether it would be appropriate to turn back the clock to the situation which was created right after the 1929 financial crisis and which aimed, more particularly, at prohibiting deposit-taking institutions to make use of deposits to engage in trading activities and proprietary trading in particular.

Today, however, a revival of the split between commercial and investment banking raises several significant objections:

- Such a split would be impractical or too difficult to implement because many core banking activities are linked nowadays with derivatives and structured products.
- Moreover, and probably more importantly, the very concept of “narrow banking” would put into question a basic policy decision taken by the EU when adopting the first Banking Directive, i.e. the choice made in favour of a universal banking model.
- One of the main advantages of the Universal Banking model is that universal banks are in a better position to diversify and, therefore, to spread risk. It may be useful to recall against this backdrop that the basic factor explaining the savings and loan crisis which hit the US in the 1980s was the fact that since the 1930s, the activities of those banks were restricted to funding their long-term mortgages with short-term deposits.

- Prohibiting deposit-taking institutions to engage in trading activities and proprietary trading would lead to the undesirable effect of reducing the number of firms that are active in the investment business. Such a market concentration would reduce competition and of the ability to spread relevant risks.
- Finally, the foundations of the narrow banking concept appear to be erroneous as recent experience has demonstrated that single investment banks pose higher systemic risks – taking into account that universal banks with an integrated investment bank can also rely on deposits even in stressed situations.

4) **Orderly resolution**

A consensus seems to be emerging that exogenous systemic risk can be reduced to a significant extent by making sure that banks are in a position to exit the market in an orderly manner.

The call for appropriate exit strategies also has to do with complexity stemming from national differences in resolution regimes and bankruptcy procedures which may result in uncoordinated behaviour from authorities in times of financial distress where cross-border banking groups are concerned. Initiatives to reduce national differences are now being prepared both on an international as on an EU level (cross border resolution tools). More particularly, the Basel Committee is proposing to develop an internationally consistent intervention and resolution regime for internationally active institutions whilst the European Commission is working towards establishing a common framework for European crisis management.

Basically, however, the call which is being made for appropriate exit strategies aims at making sure that banks are prepared for crisis situations. Therefore, bank's management needs to have in place a Recovery Plan spelling out a range of measures that may be taken to help the bank survive and recover from a stressed environment. Moreover, to be prepared for the possibility that the bank will not succeed in recovering, a Resolution Plan will need to have been put in place that will help its supervisor to wind down the bank in an orderly way, i.e. without impacting systemic risk.

- a) Recovery Plans would, more particularly, identify what the possible threats to the banking group's failure may be and explain how the bank intends to address these. Their objective would be in particular to improve the understanding of all the supervisors involved of (i) the banking group's structures (including interconnectedness within the group) as well as the reasons underlying complex arrangements; (ii) the viability of its business model; (iii) its liquidity planning (including its liquidity buffers); and (iv) its contingency planning for crisis situations. The main test to be conducted is whether the firm has undertaken an in-depth analysis of its potential weaknesses and has viable strategies in place to deal with adverse outcomes should they arise.

- b) Resolution plans would be intended to cater for the information needs of supervisors and, more particularly, aim at identifying the key aspects of the business which the Authorities need to understand in the resolution phase. This information will allow national authorities' to wind down financial institutions in an orderly way to protect depositors and other creditors, maintain financial stability, minimise systemic risk and promote market efficiency.

Obviously, there should be no requirement to publicly disclose Recovery and Resolution Plans. It would be essential, moreover, that Recovery Plans would adopt a top-down approach, which implies that they need to be set up by the parent institution on the basis of the group's situation at a consolidated level.

Many policy questions surrounding measures aiming at reducing internal complexity need to be clarified, amongst which the following can be highlighted.

- Recovery and Resolution Plans should be imposed on all financial institutions – albeit that the principle of proportionality commands differentiating according to the nature size and complexity of the financial institution. Cross-border institutions would typically prepare more sophisticated planning.
- Supervisors should be in a position to assess the adequacy of Recovery and Resolution Plans prepared by banks. We believe that it would be appropriate to make use of the Pillar 2 framework – and, in particular, the Supervisory review and Evaluation process (SREP) - in this respect.

The EBF is currently closely examining the range of issues that Recovery and Resolution Plans would need to address to deliver what could be reasonably expected from them.