How to Prevent and Better Handle the Failures of Global Systemically Important Financial Institutions

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based on:

Geneva Report on the World Economy 12

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Agenda

1. The rise of G-SIFIs
2. Problem
   - Cross-border externalities ignored
   - Home-host conflicts of interests
3. Experiences: case-studies and EU crisis
4. Financial trilemma - a choice to be made
   - Cross-border resolution: Three reform options
   - *Territoriality Universalism Intermediate*
5. Complementary steps
6. Overall summary

1. The rise of Global Systemically Important Financial Institutions (G-SIFIs)

- A small number of very large institutions have emerged (FSB names 29 banks; insurance list TBD)

- Which can be extremely complex
  - Many subsidiaries
  - In many countries, including OFCs
  - Large shares of foreign assets and income
- And large relative to economies

G-SIFIs: hard to manage and ….. hard to unwind

- Hard to manage
  - Economies of scale and scope unclear
  - Diversification discounts found
  - Anecdotal evidence suggest inefficiencies

- Hard to unwind
  - Few are resolved cleanly in normal times, let alone in a financial crisis
  - Much support during the crisis went to G-SIFIs

2. Challenge

- How to deal with the cross-border impact of failure of SIFIs (and others FIS)?

- Central question to enhance cross-border regulation and supervision

Problem

- Failure of SIFIs pose national and cross-border externalities
- Some externalities are ignored by national authorities, leading to adverse spillovers
- Others are addressed ad-hoc, creating poor/perverse responses, and new spillovers

Why?

- Accountability is to national politics (i.e., domestic taxpayers or local interest groups)
- Legislation/procedures for insolvency nation-based, harder to apply cross-border
    - Either ignore problems or resort to other tools
- Differences in fiscal/financial/supervisory capacity

Nationalism: “My country is my castle”

Conflicts among national interests especially large for SIFIs

Table 2.1. Alternative patterns of asymmetries

	HOME country/parent bank	
HOST country entity	Systemic	Non-systemic
Systemic	(a) Potential for coordination	(b) Conflicts of interest and potential for coordination problems
Non-systemic	(c) Conflicts of interest and potential for coordination problems	(d) Not a big problem

3. Case-studies: Lehman

1. Badly regulated and supervised
2. Expectations that creditors are protected
3. Failure very disruptive
4. US acted unilaterally -> orderly resolution for US broker/dealer arm with Fed funding
5. No co-operation in unwinding; message to London – bankruptcy legislation is <u>national</u>

Fortis and Dexia

1. Fortis (Belgium – Netherlands – Lux)
   – First weekend: looked like a co-operative solution
   – Second weekend: domestic objectives took over
   – Lack of co-operation consistent with Freixas model
2. Dexia (Belgium – France – Lux)
   – US sub (FSA) owned by French sub and liquidity funding from Belgian parent
   – Joint interest: looked like a co-operative "solution"
   – But temporary, eventual still default

Overall case record poor

Case	Systemic in home country	Systemic abroad	Coordination	Short-term impact on financial stability
Lehman Brothers (USA and UK)	Yes	Yes	No	Substantial instability
AIG (USA)	Yes	Yes	Unilateral bailout of units in 130+ countries by U.S. government	May have prevented further deterioration in financial markets
Fortis (Belgium, Luxembourg, Netherlands)	Yes	Yes	Partly, improvised cooperation, “make do” solution. Bailout on basis of national entities, not for the Group as a whole	Enhanced stability in Belgian and Dutch banking system, but raised questions about how other cross-border SIFIs might be handled
Dexia (Belgium, France, Luxemburg)	Yes	No	Yes, joint solution based on proportions of shares held by governments & institutional investors in 3 countries	Temporary enhanced stability, but eventual bankruptcy
Icelandic Banks (Iceland)	Yes	No	No. Iceland protected only Icelandic depositors	Instability largely limited to Iceland (some unrest with retail depositors in foreign countries)
Central & Eastern European banking systems	Mixed	Yes	Yes, joint solution based on European Bank Coordination (“Vienna”) Initiative	Some enhanced stability in both Eastern & Western Europe

Still do not know how to resolve Deutsche Bank

Issue raised in 1997 paper, no answer yet

- **Fact**: 1/4 assets of Deutsche Bank in London
- **Question**: Who steps in if Deutsche Bank experiences a big liquidity problem in its London operations, with contagion in London?
- **Possibilities**:
  - Bank of England on its own risk?
  - Bank of England on behalf of Germany?
  - Bundesbank?

EU Crisis Experiences

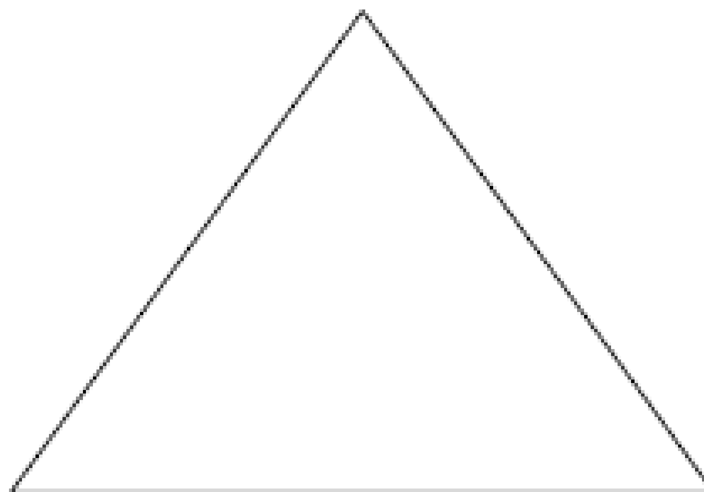
- Weak banks/banking systems in periphery countries led to perverse bank-sovereign links
- Threats of banks/sovereign default, associated contagion led to EU/ECB support (“bail-out”)
- Means large financial transfers, reinforce moral hazard, and delay (final) resolution
- Overall, real, financial and fiscal costs high(er)
- EU policy did not address *Financial Trilemma*

“Too big to fail” banks drive sovereign risks

4. Financial Trilemma: choice to be made

Figure 2.1. The financial trilemma

1. Global financial stability



2. Cross-border banks

3. National authorities

Two corner, one intermediate approach to trilemma

Two corner approaches

- **Territoriality** (ring-fence activities under one particular domain, undermines open system)
- **Universalism** (equitable distribution of estate, may require burden sharing)

One intermediate approach

- **Modified universalism**

Territorial Approach

- Advantages
  - Fiscal independence, no burden sharing
  - Better incentives for local supervision
- Disadvantages
  - Costs in times of stress (runs, trapped liquidity)
  - No/little concern for global interests/spillovers
  - Less incentives for cross-border supervision
  - Less efficient for financial institutions (sub model)
- Main concern: undermining trends towards open financial systems and political economy risks

Universal Approach

- Universal creates clarity (home authority)
- But does not avoid conflict of interests
  - When sub is systemic in host country
  - When home lacks capacity, resources, willingness
- Still requires burden sharing agreements
- Need to match other aspects
  - SIFI structure, universal best for single entity
  - Liquidity, regulation, supervision, etc.

Universal Approach unlikely soon and unlikely (or wise) global

- Too demanding to expect any time soon
  - Fiscal independence and sovereignty too tested
- Can increase overall burden to share
  - If it leads to free-riding or is too slow
  - Risky governance of world regulator/supervisor
- Yet, some process elements to be introduced
  - Akin to UNCITRAL, WTO, EC DG Competition
  - Sanctions for deviations from certain procedures
  - Not for crisis management (too slow)

Phasing in the *Universal Approach* for some group of countries

- Most suited for closely integrated countries
- But cannot be introduced overnight
- A phase-in model: *(European) Banking Charter*
  - New regime, mainly for cross-border SIFIs
  - Single supervisory authority, with all the tools
  - Including resolution regime/authority
  - Lower compliance costs for FIs plus backup
- Requires <u>good</u> centralized systems though

Can be flexible, enhance regulatory governance, increase cooperation

- Can be flexible and flexibly introduced
  - Differentiate by class of institutions
  - Allow countries to opt in
- Can enhance regulatory governance
  - Distance to political economy increased if managed by one authority (e.g., EBA, ERA)
- Clearer burden sharing enhances cooperation
  - Supervisors to become more incentivized

Can be combined with burden sharing

- Common resolution with burden sharing
  - Ex-ante, perhaps according to a key (GDP, Assets)
  - General or financial institutions' specific
  - Could use existing key (e.g., ECB profits)
- Could be complemented by a (recap) fund
  - Paid in by financial industries and/or governments
  - Multinational, backstopped by governments
- Largely for working capital (in "bridge" phase)
  - And ex-post, potentially, losses

For other countries, pursue the *Intermediate Approach*

- Less demanding, build on home-host principle
- Already many trends to enhance cooperation
  - Crisis management rules
  - Colleges, financial stability groups
- Steps so far not sufficient, though
  - Focus is still largely on supervision
  - By excluding resolution, do not address incentives
- Especially limited effectiveness in crises

5. All approaches requires three, complementary pillars

i. Improve the *structure* of SIFIs and enhance ability to *wind down* SIFIs orderly in case of weaknesses
ii. Create greater *convergence* in national rules, including those covering contingent capital, regulatory insolvency triggers and resolution
iii. Negotiate a new *Concordat* focused on crisis management and incentives for collaboration

6. Overall summary

- Approaches are not exclusive, but internal consistency in addressing trilemma is key
- Globally universal approach not likely soon/wise
- For closely integrated groups of countries, universal approach could be phased in
- Others to choose for intermediate approach
  - New *Concordat*: offers sticks and carrots approach
- Try to avoid territorial approach, race to…

A Safer World Financial System: Improving the Resolution of Systemic Institutions

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www.cepr.org/2432/ClaessensFinal.pdf

http://www.amazon.com/Safer-World-Financial-System-Institutions/dp/1907142096