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Reducing the moral hazard posed by systemically important financial institutions

Interim report to G20 Leaders

This report seeks the endorsement of the G20 Leaders for the overall direction of work on the development of a policy framework for reducing the moral hazard risks posed by systemically important financial institutions (SIFIs). Over the next months, we will build on the following principles in developing concrete policy recommendations for the Seoul Summit:

- 1. All jurisdictions should have in place a policy framework to reduce the moral hazard risks associated with systemically important financial institutions in their jurisdictions.**
- 2. All jurisdictions should have effective resolution tools that enable the authorities to resolve financial firms without systemic disruptions and without taxpayer losses. These should include powers that facilitate a “going concern” capital and liability restructuring as well as “gone concern” restructuring and wind-down measures, including the establishment of a temporary bridge bank to take over and continue operating certain essential functions.**
- 3. All jurisdictions should have the capacity to impose prudential requirements on firms commensurate with their systemic importance. There should be a presumption that national authorities would apply supplementary prudential requirements and require changes to legal and organisational structures, where necessary, in order to reduce the externalities that could arise from failure or improve the resilience or resolvability of a firm.**
- 4. All national supervisory authorities should have the powers to apply differentiated supervision requirements for institutions based on the risk they pose to the financial system. They should have appropriate mandates, powers, independence and resources to identify risk early and intervene to require changes within an institution as needed to prevent unsound practices and ensure appropriate countermeasures to offset the additional risk.**
- 5. All jurisdictions should put in place or strengthen core financial market infrastructures to reduce contagion risk upon a firm’s failure, and encourage their use. All core financial infrastructures (e.g., central counterparties) should meet standards of robustness that assure systemic stability.**
- 6. FSB members will establish an ongoing peer review process to promote national policies to address the risks associated with SIFIs that are effective in global risk**

reduction, as well as consistent and mutually supportive and thus avoid regulatory arbitrage and promote a level playing field. Supervisory colleges and crisis management groups will have an important role in seeking to ensure that the legitimate interests of home and host authorities are being taken into account and to assist in improving cooperation.

I. Overview

At Pittsburgh, G20 Leaders called on the FSB to propose by the end of October 2010 possible measures to address the “too big to fail” (TBTF) problems associated with SIFIs.

The collapse of Lehman Brothers amply demonstrated that the disorderly failure of a global financial firm has strong spillovers across markets and affects financial stability and national economies around the world. In the months that followed this event, national authorities took unprecedented steps to prevent the systemic collapse of the global financial system. While they were successful in their primary goal, these actions affirmed and sharply increased moral hazard risks in the financial system.

Absent credible steps to reduce the likelihood of bail-outs, SIFI funding costs will reflect the expectation of official support, leading SIFIs to engage in higher risk activities that distort the allocation of capital and make future crises more likely.

The FSB is developing a comprehensive policy framework to reduce the moral hazard risks associated with SIFIs. This framework will build on the broader policy actions to improve the resilience of the overall financial system, including the reforms to the Basel capital and liquidity framework. Although those policy actions would incentivise SIFIs to reduce their engagement in higher risk activities, they do not explicitly aim to address the fundamental moral hazard risks that arise from the perception that certain firms are too big or too interconnected to fail.

The framework therefore consists of a set of additional policy approaches and tools to (i) improve the capacity to resolve SIFIs without taxpayers bearing the costs; (ii) reduce the probability and impact of a SIFI failure; and (iii) strengthen the core financial market infrastructure to reduce contagion risks if failure occurs. The framework explicitly targets resolution capacity and SIFI resolvability, along with institution-focused actions to force SIFIs to internalise the externalities they impose on the system and incentivise those firms to reduce their degree of systemic importance and/or to increase their resolvability. The framework largely focuses on regulated financial institutions but has application to systemic institutions outside the regulatory perimeter as well.

The implementation of improved resolution capacity, and in particular its demonstration in the case of a large firm’s failure, will over time change the expectations of investors and creditors of SIFIs about the risks they bear in the event of failure. This will lead to greater market discipline being exerted on these firms and hence help discourage excessive risk taking. The associated reduction in mispricing of risk and distortions in resource allocation will make our financial systems more efficient and resilient.

II. Policy framework

The proposed framework will call for jurisdictions with systemic institutions to put in place policies that enable supervisory and regulatory actions to reduce the moral hazard associated with these firms. To promote national policies that are consistent and mutually reinforcing, the FSB will develop over the next several months a set of policy recommendations. At the core of these policy recommendations will be:

- (i) actions that seek to ensure that firms can be resolved safely, quickly and without destabilising the financial system and exposing the taxpayer to the risk of loss;
- (ii) the capacity for national authorities to impose, when necessary, supplementary prudential requirements on institutions and/or structural constraints that reflect the greater risks they pose to the financial system;
- (iii) more effective supervisory oversight for institutions which may pose systemic risk;
- (iv) robust core financial market infrastructures to reduce contagion risk from the failure of individual firm; and
- (v) a process that provides assurance that all countries have established effective policies to reduce moral hazard risk that are consistent and mutually reinforcing.

A. Actions that seek to ensure that failing firms can be resolved safely

1. Attributes of effective resolution regimes

Any effective approach to addressing the “too big to fail” problem needs to have effective resolution at its base. An effective resolution regime must provide the authorities with tools to act safely and quickly to resolve a firm in a manner that ensures the continued performance of essential financial functions and uninterrupted access of insured depositors to their funds, without causing a panic or destabilising the financial system, and without exposing the taxpayer to the risk of loss. Cost incurred must be recouped from the financial industry.

The FSB will set out the key features and powers of effective national resolution regimes as well as a menu of resolution tools that authorities should have at their disposal, with the ability to act at an early stage. These should include tools of burden sharing among stakeholders of financial firms such as powers to dilute or extinguish equity to absorb the losses and, if equity is extinguished, impose losses on unsecured creditors as appropriate, and to hold management accountable. The proposed resolution tools should include powers that facilitate a “going concern” capital and liability restructuring as well as “gone concern” restructuring and wind-down measures, including arrangements for the provision of temporary funding and the establishment of a temporary bridge bank to take over and continue operating certain essential functions. We are examining viable mechanisms to convert debt into equity: some of these may be contractual with the conversion triggers and terms set out in the debt instrument; however they might need to be buttressed by statutory powers in the resolution regime.

2. Cross-border resolution

National resolution tools will not be effective unless they can be applied to firms operating globally. Work is underway to identify framework conditions that should permit the effective exercise of resolution powers in a cross-border context. Where needed, changes in national laws should be made to provide the relevant national authorities with the capacity to cooperate and coordinate resolution actions across borders.

3. Removing obstacles to effective recovery and resolution actions

We have initiated further collective work in four technical areas that affect the effective implementation of recovery and resolution measures in complex cross-border institutions. These relate to (i) how and where trades are marketed, booked, funded, and risk-managed across jurisdictions and affiliates; (ii) the use of parent or lead bank guarantees to support and cover particular transactions or whole operations of affiliates in foreign jurisdictions; (iii) the critical nature of certain business services provided by a firm, such as cash management, cash payments, securities settlement and custodial services; (iv) the adequacy of the firm's information systems and ability to obtain firm-wide and legal entity specific information and accurate valuations of positions and businesses to fully inform recovery and resolution actions. We intend to propose a range of practical steps to address each of these issues.

4. Firm-specific contingency planning and resolvability assessments

We have established cross-border crisis management groups for most of the largest globally active financial institutions. The focus of these groups is on firm-specific recovery and resolution plans (RRPs) that will strengthen the authorities' and firms' capacity to handle severe stress and enhance mutual trust among key home and host authorities. Making progress on the resolution part of the RRP as much as on the recovery part will require reforms to resolution regimes in many countries.

Firm-specific plans for orderly resolution should be in place for all major cross-border institutions. A core purpose is to enable authorities to make an assessment of whether a firm is in fact resolvable without government equity support under existing resolution regimes and given the firm's existing structure. Assessments of resolvability without taxpayer losses should play a central role in the determination of the extent to which an institution should be induced to change its structures to facilitate resolution.

We will set out the key factors that affect an institution's resolvability. We will recommend that authorities step up their work on recovery and resolution plans to ensure that they are in place for all major firms and can really be used in an actual crisis.

B. Prudential requirements, structural and other constraints

Financial institutions should be subject to requirements commensurate with the risks they pose to the financial system. 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 to the level of systemic risk posed by the firm 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;

(iii) improve their resolvability and ensure that essential functions for the financial system and broader economy can continue to be performed should the firm fail.

1. Prudential requirements

We are examining supplementary prudential requirements linked to appropriate measures of systemic importance that could be applied consistently to financial institutions. These supplementary requirements could consist of a capital or liquidity surcharge linked to the systemic importance of the institution, or other prudential requirements, such as limits on large counterparty exposures. A capital surcharge could take the form of mandatory holdings of contingent capital that would convert into common equity before any public intervention occurs in case of financial distress. Together with standard-setting bodies, we are working to develop measures of systemic importance based on size, interconnectedness and substitutability that could be used to develop and calibrate surcharges and other possible responses.

2. Structural constraints

Diversity in existing business models and organisational structures, with a mix of decentralised and centralised institutions, is itself a source of systemic resilience. National authorities will assess on a firm-specific basis whether the degree of complexity that a certain structure presents warrants additional measures to reduce the probability and impact of failure. Such additional measures may consist of (i) reducing intra-group connectivity through for instance intra-group exposure limits; (ii) a structural separation of various financial activities within a group's legal and organisational structure, including requirements relating to separate incorporation and stand-alone capacity of operations that are systemically important in a financial system; and (iii) simplifying structures in a manner that aligns them more closely with the applicable regulatory and resolution frameworks.

3. Systemic levies

Other tools to constrain SIFI risk taking include the use of systemic levies. Such levies may target and reduce activity that contribute to systemic risk. While levies reduce a systemic firm's loss absorption capacity, they could supply the means to build up a resolution fund and hence facilitate resolution when such firms fail.

4. Combining measures

Given the existence of different levers to contain moral hazard, there may be a case for a degree of national discretion ("constrained" or "guided" discretion) in the application of requirements to SIFIs. The choice of a particular measure or combination of measures should be assessed against the overall objectives of reducing moral hazard and the build-up of systemic risk. This will depend on conditions in each financial system and should be targeted to the specific risks posed by SIFI institutions in each jurisdiction. However, given the nature of the risks posed by SIFIs, prudential requirements should be subject to floors or minimums. Authorities will have to consider the impact that the measures may have across home and host jurisdictions.

C. Effective supervisory oversight

We will, in cooperation with the standard setters and building on existing work, develop recommendations for more effective supervision of complex and systemic institutions. We will call for a strengthening of the mandate, powers and resources of supervisory authorities where appropriate and recommend a range of actions to render supervisory tools and practices more effective.

These recommendations will include: an increased focus on corporate governance and measures to better ensure the effectiveness of boards in overseeing the risks being taken by firms; methodological guidance to strengthen horizontal or benchmarking supervisory review processes; deeper investigation and understanding of the risks inherent within the business models of firms and the risks embedded in new innovations as well as ongoing activities (such as highly structured or complex products); better investigation into the appropriate use of quantitative models within a firm including their risks and limitations; the early identification of risks through better data collection, processing and monitoring leading to stronger on-site and off-site review work; enhanced consolidated supervision including through improved coordination among (sectoral) supervisors as well as home and host authorities; more effective use of resources within a supervisory agency to ensure that there are an appropriate number of sufficiently skilled supervisors overseeing systemic firms and that information sharing within a supervisory agency is enhanced; and effective cooperation and close coordination of supervisory activities among key home and host authorities, including through core supervisory colleges.

D. Robust core financial market infrastructures

An important reason for public intervention to avoid the failure of a financial institution is its interconnectedness with market participants. Robust core financial market infrastructures reduce the degree to which contagion can spread because of counterparty exposures. We are working with standard setters to strengthen standards for the soundness of core financial market infrastructures, including systemically important payment systems, securities settlement systems and central counterparties. We will develop recommendations to support the consistency of implementation of clearing and exchange or electronic trading requirements across jurisdictions, address the factors that make derivatives standardised and increase the share of the market that is clearable. We will encourage further actions that improve the resilience of critical financial market functions, reduce contagion and improve counterparty risk management, including the review of market documentation and the strengthening of customer asset protections through segregation and portability of customer assets.

E. Achieving consistency and coordination across home and host authorities

We will need to ensure that our national policies for SIFIs are adequate in meeting the policy objective of reducing moral hazard. National policies should be consistent and mutually supportive so as to maintain a level playing field and avoid regulatory arbitrage. Consistency of policies and actions, including supervisory practices and resolution frameworks, is particularly important in those jurisdictions in which the largest international financial

conglomerates are headquartered. We will propose the establishment of an ongoing peer review process to review and compare national policies and assess their effectiveness in reducing moral hazard.

Supervisory colleges and crisis management groups should have an important role in ensuring that the legitimate interests of home and host authorities are taken into account in the application of these policies as well as ensuring an appropriate level of information sharing between home and host authorities. An adequate degree of transparency of national policies, and the underlying factors that determine the choice of the authorities' policy measures towards a particular financial institution in their jurisdiction, will help enhance market discipline and strengthen the credibility of resolution policies.