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Reducing the Risks and Moral Hazard posed by Systemically Important Financial Institutions

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The issue

- TBTF firms contribute disproportionately to systemic risk, impose large efficiency and rescue costs
- Response to recent crisis massively expanded moral hazard risk
- G20 called on FSB to propose by the end of October 2010 possible measures to address the “too-big-to-fail” problem

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The issue

- **Long-standing problem – present in both advanced and emerging economies**
- **No "single silver bullet"**
- **No "one size fits all" solution**
  - Size and structure of institutions and financial systems (TBTF vs TBT-Save)
  - Nature and extent of ownership and cross-border linkages
  - Home versus host perspectives
- **Multi-faceted approach is needed and prudent**

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Guiding Principles - Interim Report

- All jurisdictions should have an explicit policy framework to reduce moral hazard risk posed by SIFIs
- Effective resolution tools to facilitate 'going concern' restructuring and 'gone concern' resolution and wind down, enable cross-border co-operation
- Capacity to impose supplementary prudential requirements and changes in SIFI structure
- Powers to apply differentiated supervision based on risk to the financial system
- Strengthen core financial market infrastructure
- Establish a peer review process to ensure national policies support global financial stability

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Work to give this content

Broad strands

1. Making TBTF/SIFIs resolvable w/o tax payer losses
2. Prudential, structural and other constraints to lower probability and impact of SIFI failure
3. More effective SIFI supervision, including supervisory co-operation
4. Strengthen market infrastructure to reduce contagion risk
5. Development of framework for “constrained discretion” and peer review assessment

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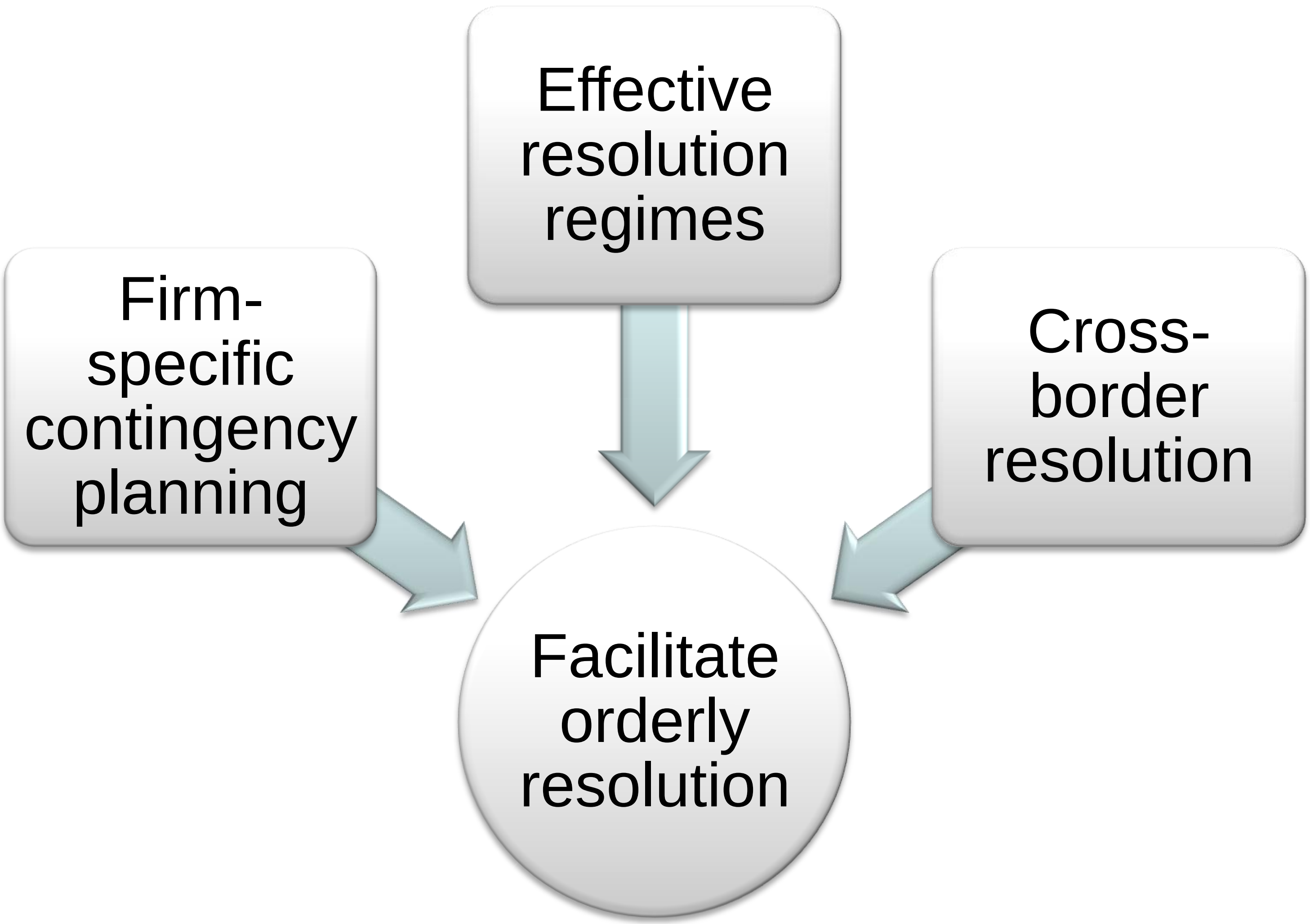
Making SIFIs Resolvable



Improving Resolution Capacity

- Attributes and tools of effective resolution regimes
- Principles and framework conditions for co-operation in cross-border resolution
  – How far are countries prepared to give up national prerogatives and control?
- Recovery and Resolution Plans for LCFIs
  – Removing obstacles to effective resolution
- Bail-in and Co-co’s as going concern or at point of non-viability

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Added Prudential Constraints

- For which institutions?
  - – Quantitative + Qualitative indicators
  - – Home authorities decide
- Measures to increase loss absorbency
  - Capital surcharges
    - – Calibrated to damage SIFI failure imposes on system
  - Co-co's or bailinable debt (contractual or as part of resolution framework)

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Structural and other constraints

- “Systemic” levies
  - Tax TBTF funding advantage using as tax base activity that contribute to build-up of systemic risk and externalities
- Structural constraints - to reduce risk, facilitate resolution
  - Restrictions on intra-group exposures
  - Structural separation of activities
  - Subsidiarization

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Effective SIFI Supervision

- Recommendations will cover
  - Powers, Mandates and Accountabilities
  - Impediments
  - Resources
  - Methods, tools, practices
  - Enhanced consolidated supervision
  - Home-cost cooperation - role of core supervisory colleges
- Fold into Basel Core Principles

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Strengthening financial infrastructure

- Robust infrastructure can shrink inter-connectedness exposures, reduce systemic risk
  - Central clearing of OTC derivatives
  - Triparty repo market
  - Segregation of client funds
- Strong robustness standards for core infrastructure is critical (e.g. CCPs)

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Constrained Discretion

- No one-size-fits-all solution to TBTF
- Legitimate tradeoffs amongst SIFI specific policy choices (e.g. capital surcharges vs. structural changes)
- But choices should be constrained and subject to challenge
- Peer review and external assessment
  - Role of supervisory colleges and crisis management groups
  - IMF FSAPs
- Fallback for host authorities is subsidiarization

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Conclusion

- Material economic gains to ending TBTF
  – Improved economic efficiency
  – Reduced probability and costs of crisis
- Political will to address TBTF stronger than before
- Clear plan of action and process of implementation expected at Seoul Summit