

Systemically Important Financial Institutions

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Outline

The crisis

Problem

Definition

Solutions

Implications

DNB's Approach

SIFIs

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The crisis with the benefit of hindsight

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Large banks that overleveraged due to the availability of **artificially cheap** wholesale and retail funding and the negligence of **negative tail risks** were rescued to protect **depositors and other counterparties** to maintain their **function to the real economy** and “**restore confidence**” in the system. **Taxpayers** paid the bill; **equity holders** suffered only lightly; providers of other **capital instruments** hardly at all.

Of course, this is a generalisation, but it highlights the problem of systemically important banks, its self reinforcing nature, and its adverse economic impact.

- ▶ Moral hazard
 - ▶ Excessive risk taking
 - ▶ Suboptimal allocation of capital
- ▶ Other negative externalities
- ▶ Level playing field
- ▶ Resolvability
 - ▶ Too big to rescue
 - ▶ Too complex to rescue
- ▶ Political economy
 - ▶ Home-host coordination
 - ▶ Tax payers' money
 - ▶ Society's outrage

Definition

- ▶ Size
- ▶ Interconnectedness
 - ▶ Exposures
 - ▶ Liquidity (broad sense)
 - ▶ Reputation
- ▶ Substitutability

Related with, but not identical to system-wide risk.

The international approach to SIFIs

SIFIs

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DNB's Approach

The Financial Stability Board to define Global SIFIs

The Basel Committee to develop a methodology to
define *global* SI Banks

Global component consists of international activity

Complexity also part of the “definition”

Challenges in defining SIFIs

- ▶ Moral hazard
- ▶ Data availability
- ▶ “Chicken and egg” problem
- ▶ Systemic importance is not a binary concept
- ▶ Systemic importance can
 - ▶ Vary over time
 - ▶ Depend on the scope of assessment (e.g. domestic vs global)

Proposed Solutions

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Reduce probability of failure

More intensive supervision

More risk sensitive capital requirements

Recovery plans

Reduce impact of failure

Higher loss absorption capacity

Large exposure rules

Liquidity requirements

Better resolution regimes

Resolution plans

Taxes and levies

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Challenges in solving the SIFI problem

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- ▶ How to assess trade off between economies of scale/scope and SIFI problem?
- ▶ What form of capital to require?
 - ▶ Equity and retained earnings (core tier1)
 - ▶ CoCo's
 - ▶ Bail in debt (statutory or contractual)
- ▶ Where to place capital in the hierarchy?

Implications

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DNB's Approach

- ▶ Systemic issues can not be addressed at an individual bank level; the good have to suffer with the bad
- ▶ Focus during great moderation was on idiosyncratic risk, benefits accrued to the large banks, now focus is on systemic risk and this will be (partially) undone
- ▶ Both *desirable* and *potentially undesirable* increases in “shadow” banking
- ▶ Lower returns, whereas perceived risk is higher

DNB's approach

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DNB's Approach

- ▶ Improved assessment of systemic importance during crisis
- ▶ More formal assessment introduced in 2010
 - ▶ Formal framework
 - ▶ Part of SREP panels
- ▶ First RRP pilot
- ▶ More steps to follow
 - ▶ Expand scope beyond banks
 - ▶ Make input for supervisory planning
 - ▶ Assess scope for capital requirements and RRPs

DNB's approach: Template

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DNB's Approach

Name of institution	
Assessment of Systemic Importance	
Structural factors	Dynamic factors
<i>Size</i> <input type="text" value="0"/>	<i>Herding behaviour</i> <input type="text" value="0"/>
<i>Interconnectedness</i> <input type="text" value="0"/>	<i>Reputation effects</i> <input type="text" value="0"/>
<i>Substitutability</i> <input type="text" value="0"/>	- <i>Market participants</i>
<i>Contribution to DGS</i> <input type="text" value="0"/>	- <i>Consumers</i>
Assessment <input type="text" value="0"/>	
Add on: limited resolvability <input type="text" value="0"/>	
Additional considerations	Additional considerations
<input type="text"/>	<input type="text"/>
Final assessment <input type="text" value="0"/>	Final assessment <input type="text" value="0"/>
Potential mitigating actions	
<input type="text"/>	

DNB's approach: Result

SIFs

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Problem

Definition

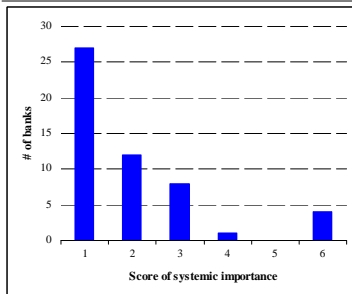
Solutions

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DNB's Approach

Assesment of systemic importance - NL

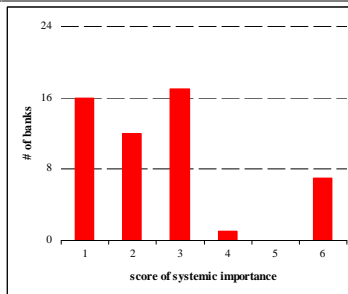
Based on structural factors



Source: DNB.

Overall assesment of systemic importance

Including dynamic factors



Source: DNB

DNB's approach

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