# Systemic risk, SIFIs and cross border resolution

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## Systemic risk and financial stability

- Inadequate systemic risk control is a feature of the 2007-2009 financial crisis.
- As a response to this inadequacy, the concept of macro-prudential supervision is embraced now by financial authorities in the EU & US. **Macro prudential supervision is analogous to the oversight of the forest, while micro prudential supervision is analogous to the oversight of individual trees.**
- The key aim of financial stability is the control of systemic risk.

Macro prudential supervision
(view of the forest)

## Definition of systemic risk

- Systemic risk refers to the risk or probability of breakdown of the entire financial system, as opposed to breakdowns in individual parts or components. It is the risk that financial difficulties at one institution or more spill over to a large number of other institutions or to the financial system as a whole.
- But a widely accepted definition is still missing. All classes of financial intermediaries, markets and infrastructures can be systematically important in some level. Any risk (not only credit risk but liquidity risk, interest rate risk, exchange rate risk, etc.) can grow into systemic proportions.

## Transmission mechanisms

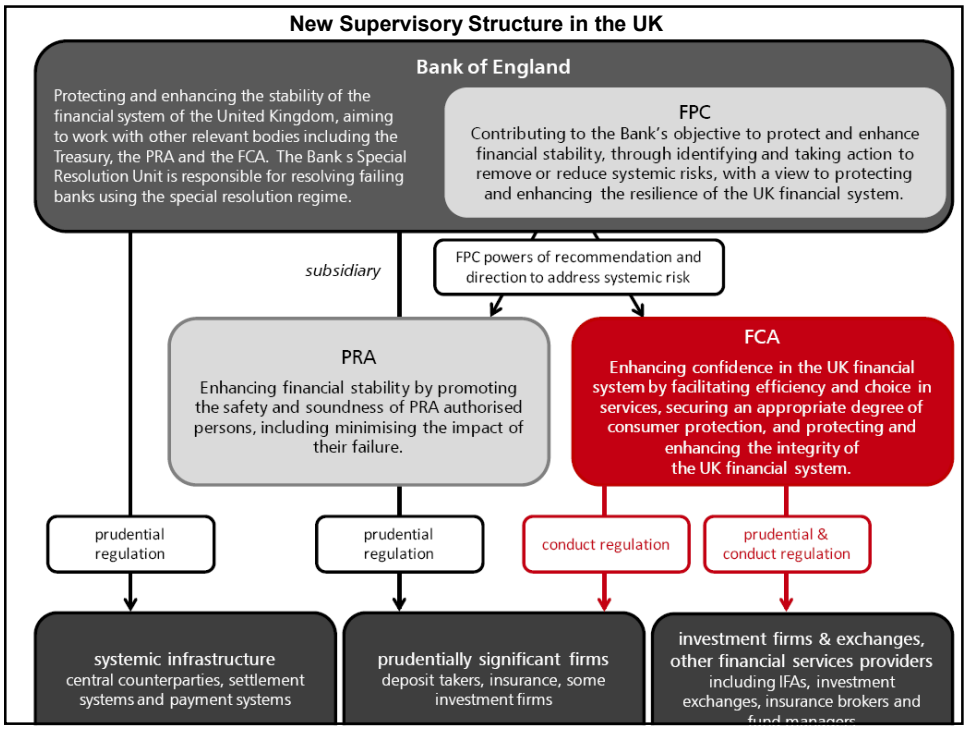
- What makes a crisis of a systemic nature is not so much the trigger event (*causa proxima*) but the transmission mechanisms, domestically and internationally. If the linkages are strong, the potential for systemic instability increases. If the connections are weak, there is less of a threat of systemic risk. No chain is stronger than its weakest link.
- The transmission mechanisms can be classified into at least four categories: (1) the inter-bank, inter-institution, inter-instrument channel; (2) the payment systems channel; (3) the information channel and (4) the psychological channel. The Minsky moment. The loss of confidence in an institution or market (whether informer or uninformed, rational or irrational) will undermine the functioning of that institution or market.

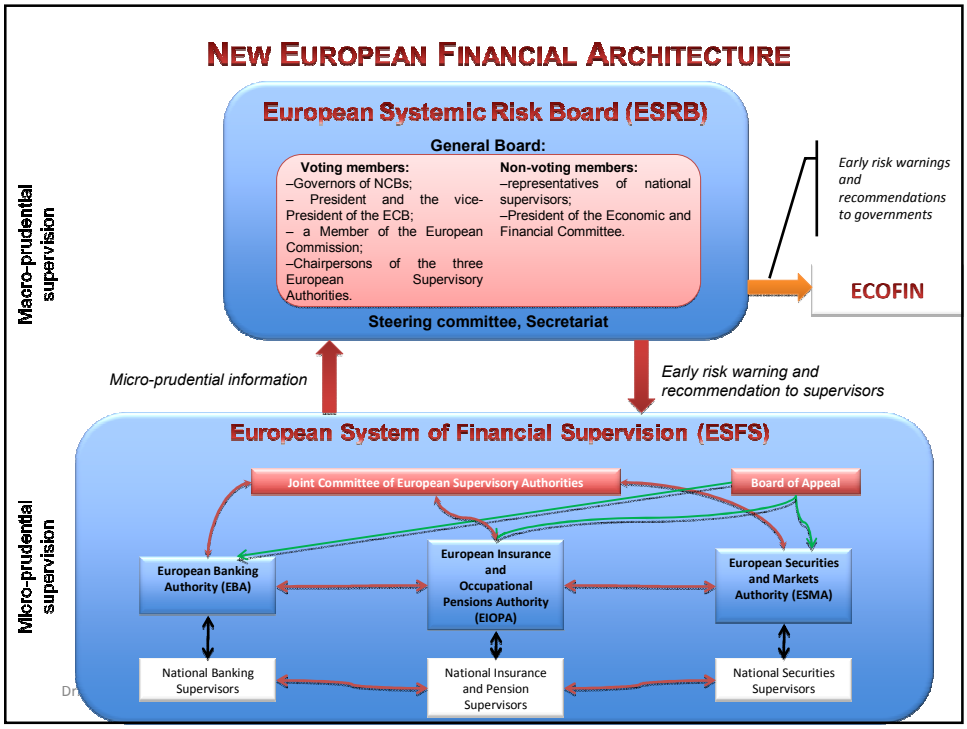
## Councils for financial stability

- Financial stability is a goal that transcends institutional boundaries and geographic borders. A variety of instruments help achieve FS : supervision (macro and micro) and regulation, lender of last resort and liquidity assistance, crisis management procedures, monetary policy, fiscal support etx
- The emergence of councils for financial stability to undertake systemic risk control or macro-prudential supervision is a feature of the Dodd Frank Act 2010 in the USA, of the legislative reform in the UK and the EU (with the establishment of the European Systemic Risk Board). It is also behind the reinforcement of the role of the Financial Stability Board and the debate about the design of an appropriate international financial architecture.

# Councils for financial stability

- The key issue is coordination; national council for financial stability should work together with other such councils in other jurisdictions, with regional councils (such as the ESRB) and with the Financial Stability Board and IMF to identify macro-economic trends that can have a negative impact on financial markets.
- Debate about WFO and functions






# SIFIs

- Systemically important financial institutions or SIFIs are institutions that are so important for the functioning of the financial system that their problems (in particular, their failure) can trigger systemic risk. SIFIs – according to the FSB Recommendations of October 2010– are financial institutions 'whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity'. Though as individual institutions SIFIs may be subject to individual micro supervision (though some SIFIs can be part of the shadow banking system and thus subject to lesser regulation or no regulation), their systemic significance implies that they should also be subject to macro prudential supervision
- The size or importance of SIFIs is a source of concern globally and nationally. The dangers of SIFIs remind me of the image of the baobabs in The Little Prince:

*The Little Prince*
Antoine du Saint Exupéry
'The baobabs'

There were some terrible seeds on the planet that was the home of the little prince, and these were the seeds of the baobab. (...) A baobab is something you will never be able to get rid of if you attend to it too late. It spreads over the entire planet. (...) And if the planet is too small and the baobabs are too many, they split it into pieces. (...) After explaining how he cleaned the seeds of the baobabs everyday he added: 'Sometimes, there is no harm in putting off a piece of work until another day. But when it is a matter of baobabs, that always means a catastrophe. (...) [T]he danger of the baobabs is so little understood, and such considerable risks would be run by anyone who might get lost on an asteroid, that for once I am breaking through my reserve. (...) I say plainly, 'watch out for the baobabs'.
'The Little Prince' by Antoine du Saint-Exupéry

# SIFIs and TBTF

- Until the financial crisis of 2007-2009 the term too big to fail (TBTF) was mostly associated with size and with banks. TBTF institutions were typically too-big-to-fail banks. However, Bear Stearns in 2008 brought a new dimension to this doctrine: some institutions were too interconnected to fail; AIG confirmed this dimension. Bear Stearns and Lehman Brothers were investment banks, while AIG was an insurance company. The TBTF doctrine had moved from [commercial] banks to securities firms and insurance companies. Systemic risk is as likely to arise from securities and derivatives markets as it is from banking markets. This makes systemic risk prevention a fundamental goal of securities regulation and of financial regulation generally, and not 'simply' of banking regulation.
- Today's SIFIs are an extension of the TBTF doctrine. Some institutions are considered to be too important to fail and/or too complex to manage, and if they are too complex to manage, they are obviously to too complex to control/supervise, since supervision should never have to be a substitute for good management.
- And the problems in Iceland in 2008 showed that some institutions were too big to save. The fiscal problems....

# SIFIs

- There are many problems associated with SIFIs: problems of definition, problems of effective regulation and supervision and problems of resolution and crisis management. SIFIs enjoy an implicit government guarantee which generates pernicious moral hazard incentives. That implicit protection must be priced according to market mechanisms (I call it 'market discipline in protection'). Adequate resolution mechanisms for SIFIs are fundamental.
- A major challenge lying ahead in the treatment of SIFIs is the boundary problem or perimeter issue. Once a definition of SIFI or global SIFI is established, a clear boundary is drawn and with it an incentive for financial institutions to position themselves on one side or another of the boundary, whichever seems more advantageous. The definition of a SIFI is also dynamic: what is systemic today is not necessarily what will be systemic in future. And the fact that most systemically significant financial institutions have a cross border dimension, calls for a cross-border solution, supra-nationally and/or internationally.

# Cross Border Resolution

- Though financial markets and institutions have grown more international in recent years, regulation remains constrained by the domain of domestic jurisdictions.
- In any financial crisis, it is necessary to have a clear and predictable legal framework in place to govern how a financial institution would be reorganized or liquidated in an orderly fashion so as not to undermine financial stability. We do not have such a framework yet with regard to cross-border banks, neither at the European level nor at the international level.
- The field of cross-border bank insolvency is still in its infant stages; some progress has been made with regard to conflict of laws or private international law rules (an example of which is the Directive 2001/24/EC on the reorganization and winding up of credit institutions) but, so far, there is no international substantive harmonized standard for banks.
- In the absence of an international insolvency legal regime, the solution to the liquidation of a bank with branches and subsidiaries in several countries isbased on national legal regimes and voluntary co-operation between different national authorities**.** This co-operation is often uneasy and the division of responsibilities between home and host country authorities remains a matter of controversy.

September 2008


# Cross Border Resolution

- **Institutions may claim to be global when they are alive (as in the case of Lehman Brothers); they become national when they are dead.**
- In the aftermath of Lehman Brothers, no one wishes another chaotic resolution. The alternative, a 'bail-out' package, is equally unpalatable. There is however, a viable solution between chaos and bail-out and that is an orderly resolution. We must reach an international agreement on the definition and understanding of bank insolvency, similar to the international agreement [soft law] on bank capital. We need adequate harmonization of bank insolvency rules and regimes, as well as effective coordination between insolvency proceedings involving different jurisdictions.
- By analogy with the WTO's dispute settlement, which is a central pillar of the multilateral trading system, in the field of international finance we need to devise appropriate mechanisms for the settlement of financial disputes.
- The crisis has shown that the pursuit of the private interest is at times greatly misaligned with the pursuit of the common good and that, <u>with cross border banks and financial institutions, national solutions alone or uncoordinated national solutions are not enough to combat systemic risk.</u>