Financial Services Management

Global Standards on Systemic Regulation

CFO	Risk Management Action Item

Cite

Interim Report to G20 Leaders

Reducing the Moral Hazard Posed by Systemically Important Financial Institutions

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Overview

As the U.S. gets down to work on its new systemic-regulatory framework, this report analyzes new standards from the Financial Stability Board (FSB) developed for the G-20 summit.[1] The statement settles principles on reducing moral hazard on which the FSB will now work to provide the G-20 with specific recommendations for the November summit in Seoul. These will have significant bearing on an array of pending systemic-risk policy initiatives, detailed in this report. New directions are set here in several key areas – for example, by positing the use of intragroup exposure limits and/or parent-firm guarantees to address cross-border resolution concerns. New standards are also under consideration for financial-market utilities (going beyond the clearing systems addressed in the Dodd-Frank Act,[2] also to address securities lending, cash-management and custody operations). Other pending initiatives focus on board responsibilities and more traditional risk-management issues as yet unaddressed outside individual Basel Committee and home-country rules. Importantly, global regulators have now agreed that there should be a systemic-risk capital and/or prudential "surcharge," a requirement already mandated by the Dodd-Frank Act.[3] If the G-20 Summit

[1] See Client Report **SUMMIT9**, June 28, 2010.

[2] See Client Report **PAYMENT11**, *Financial Services Management*, July 23, 2010.

[3] See Client Report **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

concurs with this, the recommendation will determine both the final surcharge and its competitive impact on large U.S. firms. The FSB posits that break-up determinations by regulators should be based on judgments about whether taxpayers are at risk, a key finding that will influence pending U.S. regulatory action in this area and the ongoing debate about a new "financial crisis responsibility fee."[4]

Analysis

As noted, major policy initiatives will be heavily influenced by the FSB's determinations. These include Dodd-Frank mandated U.S. decisions on which firms are systemic (triggering significant new rules),[5] the details of systemic resolutions,[6] and studies that will guide policy on whether big banks should be broken up[7] and if concentration limits should apply.[8] New FSB action also drives "living will" requirements,[9] "ring-fencing,"[10] and how financial institutions should ensure that taxpayers do not bear resolution costs.[11]

A. Resolution

1. National Regimes

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 immediate disposal. These should include tools of burden sharing among stakeholders of financial firms such as powers to dilute or extinguish equity to absorb losses and, if equity is extinguished, impose losses on unsecured creditors, and to hold management accountable. The proposed resolution tools should include powers that facilitate a "going concern" capital and liability restructuring as well as going-concern restructuring and wind-down measures, including temporary funding and bridge banks.

The FSB is specifically 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. The U.S. has already

[4] See Client Report **CRISISFEE4**, May 4, 2010.
[5] See Client Report **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.
[6] See Client Report **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.
[7] See Client Report **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.
[8] See Client Report **FHC19**, *Financial Services Management,* July 28, 2010.
[9] See Client Report **LIVINGWILL**, *Financial Services Management*, May 20, 2010.
[10] See Client Report **SYSTEMIC14**, *Financial Services Management*, October 23, 2009.
[11] See Client Report **CRISISFEE3**, April 21, 2010.

established a statutory framework for contingent capital,[12] although it is not yet certain if any such requirement will be finalized.

2. Cross-Border

The FSB is working on specific policies regarding:

- how and where trades are marketed, booked, funded, and risk-managed across jurisdictions and affiliates;
- the use of parent or lead bank guarantees to cover particular transactions or whole operations of affiliates in foreign jurisdictions;
- the critical nature of certain business services provided by a firm, such as cash management, cash payments, securities settlement and custodial services; and
- adequacy of information systems and ability to obtain firm-wide and legal-entity information and accurate valuations of positions and businesses.

3. Resolution Plans

Firm-specific plans for orderly resolution should be in place for all major cross-border institutions. A key evaluation criterion is the degree to which taxpayers are put at risk, with the FSB indicating that this should drive breakup or other regulatory determinations. The FSB will determine factors that drive resolvability.

B. Prudential Requirements

The FSB is considering an array of requirements with the view of establishing minimums that would then be adjusted by national regulators. Supplementary requirements for systemic firms 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. Together with standard-setting bodies, the FSBs 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. These include:

- intra-group exposure limits;

12 See Client Report **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

- structural separation of various financial activities within a group's legal and organizational structure, including requirements relating to separate incorporation and stand-alone capacity of operations that are systemically important; and
- simplifying structures to align them more closely with the applicable regulatory and resolution frameworks.

C. Supervisory Initiatives

These include:

- an increased focus on corporate governance and measures to better ensure the effectiveness of boards in overseeing risk;
- 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 innovations, as well as in 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;
- early identification of risks through better data collection, processing and monitoring, leading to stronger on-and off-site review; and
- enhanced consolidated supervision, including through improved coordination among supervisors in different industry sectors, as well as between home and host authorities.

D. Financial Market Utilities and Infrastructure

Pending recommendations here support the consistency of implementation of clearing and exchange or electronic trading requirements across jurisdictions, address the factors that make derivatives standardized and increase the share of the market that is clearable. The FSB 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.