Executive summary

- The financial crisis has led to multiple reviews of systemic risk in the global financial system as governments and regulators seek to mitigate such risks in order to achieve sustainable financial stability.

- Many of these regulatory proposals are calling for the identification of Systemically Important Financial Institutions as a means of managing systemic risk and achieving stability but AFME believes this could create an imbalance in the markets.

- Firms not designated as SIFI also pose risks that could go unnoticed. Therefore a solution is required that develops regulations that address specific risks in all firms, no matter what their size and role in the markets.

- A combination of relevant, coordinated macro- and micro-prudential regulation could achieve these risk management and stability objectives without the need to label some firms as systemically important.

As all stakeholders consider the steps needed to develop a more resilient financial system that should never again need taxpayer funds to be used to save it, the regulatory architecture that is chosen and how it is implemented has a significant role to play in the success, or otherwise, of both the financial services industry and the wider economy.

Commentators agree that there was a “macro-prudential gap” that contributed to the severity of the last crisis. How that gap is filled at the national, European and global level is critical to the future resiliency of the system and the economic prosperity of us all. This chapter focuses on certain aspects of systemic risk and details our views on some of the key areas, specifically regarding so-called Systemically Important Financial Institutions (SIFI).

There is a legitimate concern as to whether regulators will always be able to measure and react to market circumstances swiftly enough to mitigate fast-moving systemic risk, or whether they will always be capable of predicting those imbalances and risks that are likely to become critical for financial stability. If reforms in these areas are overly restrictive, disproportionate, or not sufficiently coordinated, they will create a significant drag on the financial system and, therefore, on economic growth. To continuously get the balance of these factors right will certainly be difficult, perhaps impossible, and will require ongoing adjustment as the impact and effects of policy decisions are understood. What is more certain and universally agreed is that both the industry and the regulators must work together and make every effort to get this right.

This more holistic view of risk requires a regime of coordinated macro- and micro-prudential regulation, supported by an effective, efficient and consistent supervisory programme. With such a regime in place, identifying which institutions should or should not be classified as Systemically Important need not be considered an essential regulatory objective.

Clear Objectives and Shared Understanding

A significant component of any solution will be a clear definition of financial stability and a shared understanding of how to ensure it.

Publication of agreed objectives is a valuable – and under-used – policy
1. Financial stability and systemic risk

Tool that has an important role to play in bridging the sometimes lengthy intervals between identifying issues and implementing coordinated and effective regulatory solutions. If the policy objectives and regulatory tools are clearly understood, individual behaviour and business models can be adjusted accordingly, and the need for regulatory action reduced or eliminated.

There are core principles in defining financial stability that should be universally understood:

Firstly, “financial stability” should not protect badly run firms. Firm failures are normal in a functioning economy and generally will not threaten financial stability or require taxpayer support.

Secondly, a financially stable system will always carry some risk. Participants retain the duty to assess that risk and make individual judgements, geared to individual risk appetite. The focus should be on identifying, understanding and, where possible, mitigating risk.

Thirdly, all participants – firms, customers and regulators – should share a common understanding of what is desirable in a healthy financial marketplace and whether regulatory or market solutions are the best way to achieve that vision.

There is no doubt that financial stability is a complex topic. Detailed objective setting will be most effective when it is seen to have been the outcome of a robust and challenging consultation process in which the appropriate expertise is applied to consider both the likely and unlikely, or unintended, consequences of the goals being set.

For the process to be most effective there needs to be universal buy-in not just to the objectives but also to the timeframe over which these will be achieved and to the steps that need to be taken to ensure financial stability. It is vital that a consistent policy is developed and allowed to mature and that the number of measures implemented that subsequently need to be reversed, or significantly revised, are kept to a minimum.

Systemic risk needs to be measured and monitored in the context of the defined financial stability objectives. The extent to which this can be undertaken effectively will determine the long-term resilience, and performance more generally, of the financial system. In today’s global markets any regulatory response to systemic risk must be well coordinated and evenly applied. The “squashed balloon effect” that can result from pressure being applied unevenly to parts of the system must be avoided as it allows risks to build “unseen” within the system, while at the same time provides a false sense of security.

“In today’s global markets any regulatory response to systemic risk must be well coordinated and evenly applied”
Important factors

In the global banking system and markets, where imbalances in supply and demand exist, confidence (or just as importantly a lack of confidence) will determine the scale and scope of any crisis. Market participants must have complete confidence that:

- the transactional obligations of their counterparts will be met in full as they fall due;
- the market will continue to provide a price at which there will be sufficient liquidity to transact; and
- they will, therefore, be able to continually adjust their risk position.

Only where such confidence is seriously threatened do we see a rush to buy or sell, a flight to safety, a stampede for liquidity, a run on the bank or other disorderly unwinding of positions that cause the massive disruptions that concern regulators and firms and lead to bubbles and crisis.

It is important to realise that there is no one cause of a loss of confidence and we need to guard against views that link systemic importance simply to size, interconnectedness, complexity, a particular product, or any other single factor. Systemic risk should be determined in line with the financial stability definitions and measured and mitigated using a combination of macro- and micro-prudential tools in an efficient and effective supervisory structure.

There are no hard boundaries between systemic and non-systemic risk. Indeed, different tools are required for different circumstances. The tools that work well in a steady state environment may well be significantly different from those required in crisis, or situations building to crisis. There is therefore a need to continually assess both the objectives and the regulatory tools that are used to influence behaviours. Sound judgement by experienced regulators that considers the issues in the round and with proper coordination at the global level, will be vital.

“Sound judgment by experienced regulators will be vital”
1. Financial stability and systemic risk

**The Existing Landscape**

The participants in the global financial services industry cover a wide spectrum. They display diversity in legal structure, product capability, size, complexity, interconnectedness, geographical reach, risk profile and corporate governance, to name but a few. The debate on systemic risk seems, however, to have focused on how a higher regulatory threshold should be set for the small population of larger firms, rather than whether individual risks should be measured for all and consistent action taken across the complete population of firms with those particular risks. This is despite the fact that not all failed firms in the crisis were the largest or most complex participants in the industry.

Whilst there is a significant volume of published material on large, complex multinational institutions and how they provide value-added services and significant benefits to the economies in which they operate, there seems to be a considerable risk of these real benefits being disregarded when setting the new regulatory requirements.

Large multi-functional, multi-national institutions can bring benefits such as:

- increasing investment choices by providing access to products from the global marketplace;
- providing the necessary scale for certain types of business, which allows broader product choices and lower costs to consumers;
- facilitating access to finance by allowing global savings and investment flows to government, corporate and individual borrowers that would not otherwise have access to such diverse funding sources;
- encouraging international trade by maintaining and improving the payments infrastructure;
- promulgating and driving good business practices across national boundaries;
- increasing the resilience of the financial system through their capital strength, business models, reputation and brand awareness, which reinforces investor confidence;
- utilising local experience and resources in global businesses and thereby providing growth, employment, education opportunities and infrastructure that would otherwise be difficult to replicate;
- increasing product standardisation and understanding to enable cross-border business to be concluded and risks to be managed more effectively; and
- achieving higher corporate governance standards with improved separation and independence of control and risk functions, and “best in class” systems and management.

“Labelling certain institutions as systemically important will not achieve the improvement in financial stability being sought”

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2 See, for example, IIF “Systemic Risk and Systemically Important Firms: An Integrated Approach”
The diversification that large internationally active firms achieve helps them to absorb local, regional and market shocks and therefore contribute to global financial stability. From a regulatory perspective large internationally active firms also provide access to data that would be more expensive and difficult to obtain in a fragmented global market.

Proposed structural reforms that limit banks by size, scale or function, or require the separation of certain activities by function or legal entity structure, are simplistic, unworkable and will not help achieve the required objectives. Global businesses are required for global markets so it is important that any new measures do not undermine these benefits and that proper account is taken as to how well risks are managed within such institutions.

Interconnectedness

Given the complexity of the financial services industry and the interconnectedness of its participants, there is significant focus on network analysis to understand cause and effect and the appropriate regulatory tools to use for particular issues. The rational response for an individual institution in certain circumstances can create severe macro-prudential risk when replicated by other institutions. Given the speed with which these risks originate and move through the system, the focus on individual institutions needs to be carefully reconsidered. For example, the hoarding of liquidity by individual banks during the crisis caused stresses in the money markets that, in turn, forced asset sales that depressed prices and caused other institutions to be caught in the crisis. Many individual institutions acting in the same way under micro-prudential policy can, in fact, create the greater magnitude macro-prudential risks.

Furthermore, it is vital to ensure that regulatory action does not increase systemic risk by using tools that do not act on all the elements of the identified risk in the same way. In the above example, a regulatory response that prohibits just some institutions from selling assets into such a downward trend (for fear of increasing the scale of the fall) may actually result in increased risk for those institutions and ultimately endanger their survival should those that are not restricted continue to drive asset prices lower.

The authorities’ work on interconnectedness should not be limited to banks – just as important could be the potential threat to financial stability posed by other participants, such as clearing houses, exchanges, large investors, other types of financial institutions or governments.

Systemically Important Financial Institutions

We believe that publicly designating financial institutions as “systemically important” and developing reforms aimed solely at the treatment of such institutions will not meet the authorities’ objective of maintaining financial stability. Indeed, such a list could, paradoxically, produce the very opposite as firms known to be on it may be assumed by customers and counterparties to be “too big to fail”.

However, if there were to be a regulatory definition of SIFI we believe that significant issues would need to be resolved, including:

- Identifying the relevant threshold for reaching such a designation would be difficult to determine. We believe that no one criterion appropriately represents a good proxy for this purpose and that the complexity of systemic risk means that a blend of factors is necessary. These blends are likely to require consistent and continuous recalibration to ensure they match the existing state of the industry – taking into account new products, processes, technologies and other significant risk factors and mitigating controls imposed elsewhere in the regulatory tool kit.

- Any threshold test is unlikely to be sophisticated enough to exactly match the risks upon which the policy objectives are focused. Regulators could therefore focus on institutions that have been caught by the threshold but do not run significant amounts of systemic risk or fail to monitor institutions below the threshold that can contribute to certain significant systemic risks.

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1 The Basel Committee on Banking Supervision highlights that there are some significant drawbacks with identifying SIFI. It is “not an easy task” and potentially has associated moral hazard issues. See Consultation Paper: Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability - issued August 2010 for Comment by 1 October 2010
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- Any threshold, especially where it is complicated to set, will pose difficulty in determining when individual institutions have crossed it. Where particularly severe consequences stem from meeting such thresholds, institutions will be incentivised to meet, maintain or fall below the relevant triggers. Regulators will need to be aware of the possible unintended consequences of such an approach and the possible transfers of risks between institutions, or to the non-regulated sector. These transfers may well create disruptive imbalances or asset flows that make detection of systemic risk more difficult.
- The identification and labelling of particular firms as systemically important will have an impact on moral hazard and the transparency of the obligations associated with such a status may well affect systemic risk, competition and public ratings, while also creating barriers to entry and significantly altering funding costs.
- Any threshold test would need to be consistent and coordinated nationally, regionally and globally.

Coordinated Micro and Macro Supervision

The European Supervision package very legitimately addresses this fundamental issue. An optimal environment would feature an effective, coordinated combination of micro- and macro-prudential supervision. The macro-prudential focus on identifying, measuring and mitigating systemic risk, coupled sensibly with micro-prudential assessment of risks at individual institutions and how they are mitigated, should provide a solid foundation for improved financial stability. This top down and bottom up approach has significant policy and practical advantages and will allow risks to be identified and mitigated risk-by-risk, rather than through a focus on just particular types of participant.

We believe that the proper supervision of institutions within such a framework would be a far more effective regulatory tool than any “one size fits all” attempt to classify firms, and that any requirement to subsidiarise, reduce by size or scope, or break up institutions by particular function would be a simplistic, and probably futile, attempt to achieve the same objective.

A holistic approach to systemic risk could ensure that:
- systemic risks that occur or build up outside any particular group of participants are capable of being identified;
- regulators have a more complete view of the risk profile of the system and how this applies to those that they regulate;
- risk mitigation tools are applied only to those participants that can contribute to the specific risks concerned;
- any identified risk is treated in the same way by all institutions that have it, rather than just a specified subset of the population – a point noted and included in the current UK regulatory reform proposals;
- risks are appropriately identified, managed and mitigated by the population exhibiting such risk profile, and those without such risks are not directly affected;
- sound industry practices are promulgated via the supervisory process;
- the moral hazard issues are minimised; and
- recalibration of the systemic risk analysis can be carried out continually and without any associated transparency issues that would apply to moving institutions in or out of a particular category.

Conclusion

The latest crisis was global in nature and it is therefore vital that regulatory reform is internationally coordinated and consistently and evenly implemented. Large parts of the financial system, including many large, complex, well-run multinational institutions, continued to function well during the crisis. Equally, some smaller, less complex institutions failed. The benefits of large multinational institutions to the financial system and global economy as a whole should not be underestimated and must be appropriately safeguarded within the reforms designed to maintain and improve financial stability.
The industry understands the urgency with which this work needs to be completed and is keen to ensure it plays its part in promulgating suitable regulatory reform across a wide range of subjects. Any new regulatory structure and associated tools for the achievement of financial stability must not be so conservative as to excessively drag on economic growth and should allow for the possibility of individual institutional failure within a structure that can assess and limit the contagion risk of such failure.

The public labelling of certain institutions as systemically important that is being sought. An effective combination of micro- and macro-prudential supervision would provide a holistic overview of risk and give the industry and regulators the best opportunity to deal effectively with systemic risk. This requires firms to have in place robust processes for identifying, assessing and mitigating risk. While risk management requires specialist expertise, responsibility for any corporate entity’s stability rests ultimately with its Board. It is to this responsibility that we turn in the next chapter.

**Further reading:**

IIF Systemic Risk and Systemically Important Firms- An integrated Approach

Basel Committee on Banking Supervision Consultation Document Proposal to ensure the loss absorbency of regulatory capital at the point of non viability
www.bis.org/publ/bcbs174.htm

IMF Staff Position paper Redesigning the contours of the Future Financial System

**Significant regulatory initiatives:**

Proposals to strengthen financial supervision in Europe:
Commission adopts legislative proposals to strengthen financial supervision in Europe

Community macro prudential oversight of the financial system and establishing a European Systemic Risk Board

Public Consultation regarding an EU framework for Cross-Border Crisis Management in the Banking Sector

New framework to increase transparency and ensure coordination for short selling and Credit Default Swaps

SIFI Capital Charges:
Group of Governors and Heads of Supervision announces higher global minimum capital standards, 12 September 2010:
http://www.bis.org/press/p100912.htm

ECB
ECB paper: Financial Stability Review
June 2010:
http://www.ecb.int/pub/ssf/shared/pdf/ivcfinancialstabilityreview201006en.pdf?c6dccc2e95c1bcfd0a36c9d1b5f98e0

Debate and future outcomes on “Breaking up the Banks” (UK)
Consultation: A new approach to financial regulation: judgment, focus and stability
Consultation page:
http://www.hm-treasury.gov.uk/consult_financial_regulation.htm
Consultation PDF
http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf