SIFIs: What remains to be done?
A host-country perspective

Systemically Important Financial Institutions: Priorities and Policies in a Volatile World

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*The views and opinions expressed in this presentation are those of the author and do not necessarily reflect the official policy or position of the Bank of Mexico
What we have done …

• **Reduce probability of failure**
  
  o Higher quantity and quality of capital, leverage ratios, liquidity requirements, enhanced supervision, compensation practices

  o Capital surcharges for G-SIBs

  o Supervisory colleges

• **Reduce impact of failure**

  o Improve resolution regimes (FSB Key Attributes).

  o Enhance preparedness: Crisis management groups, recovery and resolution plans (RRPs), resolution strategies.

• **Strengthen financial infrastructures to reduce potential for contagion**

  o Standardize OTC derivatives, settlement in CCPs, use of trade repositories
Global banks are comprised of a constellation of diverse legal entities established in different jurisdictions.

- They enjoy the protection of several safety nets
- In each jurisdiction, the local authority is accountable only to its own constituency
Global banks are managed as single economic units

- Most global banks assess their risks and estimate their capital requirements at the consolidated level.
- Their subsidiaries’ business decisions must take into account the impact on their parent banks’ capital and the home-country’s regulations and supervisory guidance.
- **Home-country regulation prevails**

Dichotomy between legal and economic realities
Consortium triggers of capital instruments

*Capital instruments issued by subsidiaries of global banks can only be counted in global banks’ capital when home authorities can trigger conversion*

- Parent banks are not legally obligated to support their subsidiaries
- However, subsidiaries may serve as a source of strength for parent banks
- Holders of capital instruments issued by subsidiaries may face losses when parent banks run into trouble

*Basel III capital rules’ additional criteria were set out in the BCBS press release: Annex: Minimum requirements to ensure loss absorbency at the point of non-viability in “Final elements of the reforms to raise the quality of regulatory capital” issued by the Basel Committee, January 2011.*
Host-country concerns

Capital surcharges for G-SIBs

- **Assymetric distribution of costs and benefits**
  - Cost of additional capital will be borne by parent banks and subsidiaries
  - However, subsidiaries are not assured access to additional capacity

- **Host-country authorities may also impose capital surcharges**

- **Need for close coordination between home and host authorities**
Host-country concerns

Cross-border resolutions

- Each financial authority is accountable to its own local constituency:
  - Natural tendency to ring-fence
  - Natural reluctance and legal impediments to share information
  - Asymmetric treatment of creditors (no international consistency in creditor hierarchies)
  - Lack of cross-jurisdictional burden-sharing agreements

- Difficult to delegate resolution powers and responsibilities to a foreign authority

Are these concerns being addressed by the FSB work on resolution (e.g. KAs)?

- Information-sharing issues: recovery plans, non-CMG hosts
- Will resolution strategies (i.e., SPE, MPE) work?
Single point of entry

Application of resolution powers at the top level by a single resolution authority

- Up-streaming losses and down-streaming capital

Preconditions:

- Identify affiliates providing critical functions which may trigger the strategy
- Adequate amount of loss-absorbing capacity at the top of the group and “in the right hands”

Concerns:

- Assurances to host countries by the home (loans from parent to subsidiary)
- Who defines how critical a particular subsidiary is?
- Natural reluctance to share cross-border losses
- Who triggers cross-border bail-in (including intra-group debt)?
Multiple points of entry

Application of resolution powers by two or more resolution authorities to multiple parts of the group

Preconditions:

- *Ability to stand alone*
  - Each legal entity subject to a separate resolution should have sufficient LAC
  - Intra-group funding should be provided at “arm’s length”
  - *Continuity of critical functions (e.g., MIS, IT, etc.)*

Concerns

- *Cross-border coordination risk*
A need for additional measures?

- Size limits
- Prohibition of certain activities
- Ring-fencing certain activities
- Ring-fencing local operations
A need for additional measures?

The financial crisis has triggered a reassessment of the economic costs and benefits of universal banking

- Reform objectives
  - Separate vital banking activities from riskier ones
  - Protect national or regional safety nets
  - Facilitate resolution
  - Reduce moral hazard
A need for additional measures?

- No evidence supporting the idea that particular business models were more resilient or particularly weak

- Mixed empirical findings about scale and scope economies in banking

- Drawbacks
  - Risky activities could migrate to the shadow banking
  - Need to adequately regulate/separate shadow banking
  - Spill over effects to host-countries
  - Risk of Balkanization
Liikanen:  
• Proprietary trading and market-making in separate subsidiaries

Vicker:  
• Ring-fence narrow set of retail banking businesses  
• Higher capital requirements for the ring-fenced entity
Volcker Rule

- Restrictions on proprietary trading
- **Exemptions**: market-making, hedging, trading in U.S. government securities, trading outside U.S.
- **Covered banking entities**:
  - Subsidiaries of U.S. banks,
  - Institutions with a local presence in the U.S.,
  - Institutions using U.S. infrastructure
- **Important negative impacts in economies with a large presence of US banks**
Banks’ trading activities are essential to preserve liquidity and efficiency in many EMDE financial markets

- Decrease liquidity (and increase volatility) in non-U.S. debt markets
- Limit the ability of banks, mutual funds and other institutional investors to efficiently manage their investments and risks
- Increase funding costs for governments and corporate issuers
- Trigger decreases in the value of existing financial instruments held by pension funds, institutions, and customers
- Promote fragmentation of local financial markets
The ability of banks to manage their risks and liquidity

- Banks actively use local government securities to manage their risks and liquidity
- Banks need to hold high credit quality liquid assets (HQLA) denominated in local currency for liquidity purposes. The best HQLA are local government securities
- Decrease ability of U.S. bank subsidiaries to manage their risks and liquidity in non-dollar currencies
Volcker Rule

- Promote fragmentation of local financial markets
- Hamper the ability of the subsidiaries of U.S. banks to compete as other market participants will shy away from trading with them.
Volcker Rule

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Instrumentation of monetary policy

- Accumulation of foreign reserves by many emerging market economies
- Central banks need to sterilize liquidity
- Proprietary trading restrictions might force central banks to rely on nonmarket instruments such as reserve requirements

**Net autonomous factors**

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<th>Year</th>
<th>Autonomous Factors</th>
<th>Billion of pesos</th>
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**Central bank liquidity operations – absorbing liquidity**

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1/ Autonomous factors include: International Reserves (liquidity providing)
- Banks Notes in Circulation – Government Deposits (liquidity absorbing).
“We should note that one of the fundamental elements of the current approach--our ability, as host supervisors, to rely on the foreign bank to act as a source of strength to its U.S. operations--has come into question in the wake of the crisis.”

Daniel K. Tarullo, November 2012
Ring-fencing subsidiaries

- Foreign banks can only operate through subsidiaries
- Limits to subsidiaries’ risk exposures to parent banks
- Need of authorization for significant transfers of assets and liabilities between subsidiaries and parent banks
- Capital instruments allowed only for subsidiaries listed in stock exchanges

Lending by local subsidiaries to their foreign parent banks

[Graph showing data from 2007 to 2013 with a peak in 2009 during the Lehman bankruptcy period]
Conclusions

• No silver bullet

• Need to combine:
  o *High capital levels with absorption capacity*
  o *Appropriate incentives*
  o *Effective supervision*

• Need to better align legal and economic frameworks

• Co-ordination of home and host-country efforts is essential

• Important to evaluate cost and benefits, particularly spill-overs to third countries