

SIMIs. THE SPANISH APPROACH

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The views expressed here are those of the author and not necessarily those of the Banco de España

FINANCIAL STABILITY DEPARTMENT



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Crisis and systemic institutions



- The crisis showed up major problems at some large/complex/interconnected (systemic) institutions
 - Too much leverage (i.e. tangible equity over total assets between 1% and 2%)
 - Poor risk management
 - *Lack of understanding of the risk drivers*
 - *Lack of swiftness in hedging risks*
 - Poor corporate governance
 - *Short-termism in both managers and shareholders*
 - *Poor liquidity management*

Crisis and systemic institutions



- The crisis showed deficiencies in regulation and supervision of systemic institutions
 - Insufficient micro prudential supervision
 - *Need for more intrusive analysis of risk and incentives*
 - *Careful analysis of new products and markets, in particular those more complex, opaque and concentrated*
 - Existing regulation not properly enforced
 - *A case in point were conduits and SIVs:*
 - Sponsored by banks, controlled by banks, tacit or implicit liquidity backing, income relevant for the bank...
 - Parallel banks without capital

Crisis and systemic institutions



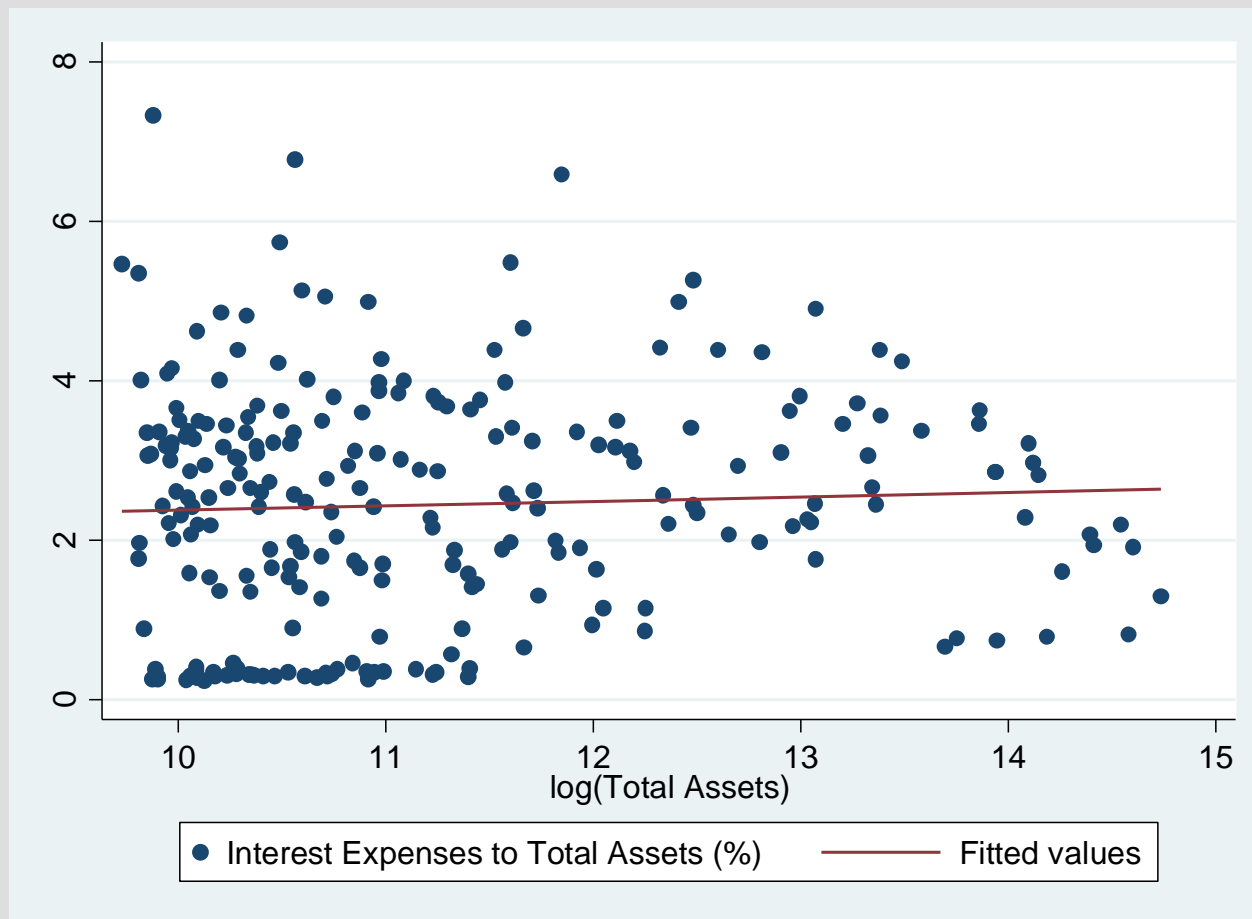
- The crisis showed clear difficulties in crisis management and, in particular, resolution of systemic institutions
 - Lack of contingency plans
 - Lack of a common resolution framework
 - *(e.g. Europe, even across highly integrated banking systems)*
- All in all, systemic institutions deserve special attention because of their impact in the financial system and the economy in case of failure...
- ...but, importantly, we must focus on the proper targets and the adequate tools to deal with them

Definition of a systemic institution



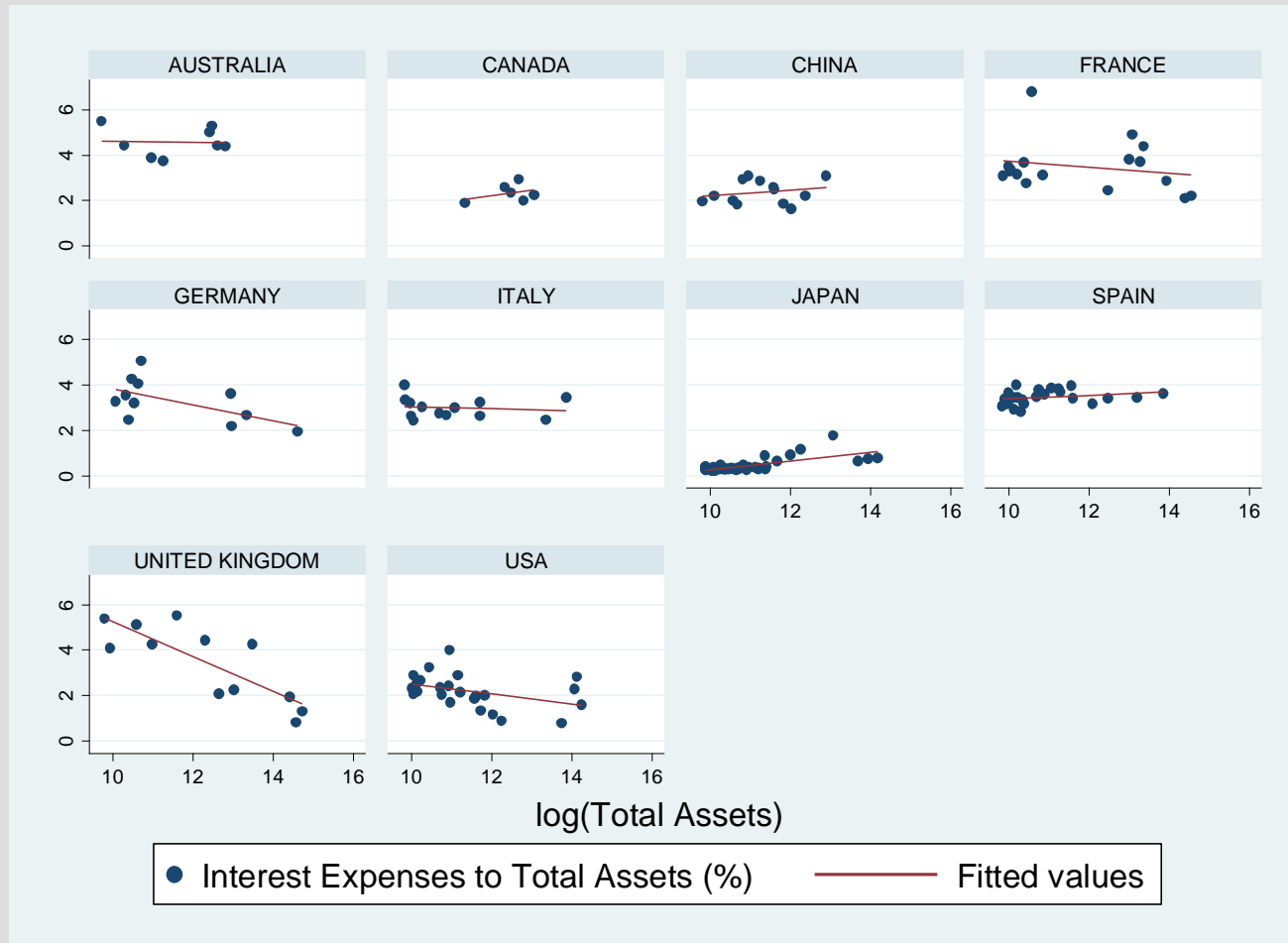
- Quick shortcut: size of the bank
- It seems clear that size is not the only driver of systemic risk, although it is the easiest one to measure
- Interconnections are also a key factor...
 - Repo transactions
 - Interbank loans
- ...as well as lack of substitutability
 - Large concentration of few players in derivative markets (e.g. top 5 dealers account for more than 95% of total notional amounts of outstanding derivative contracts in US banks)
 - Some of these markets are rather opaque

Cost of funding vs size



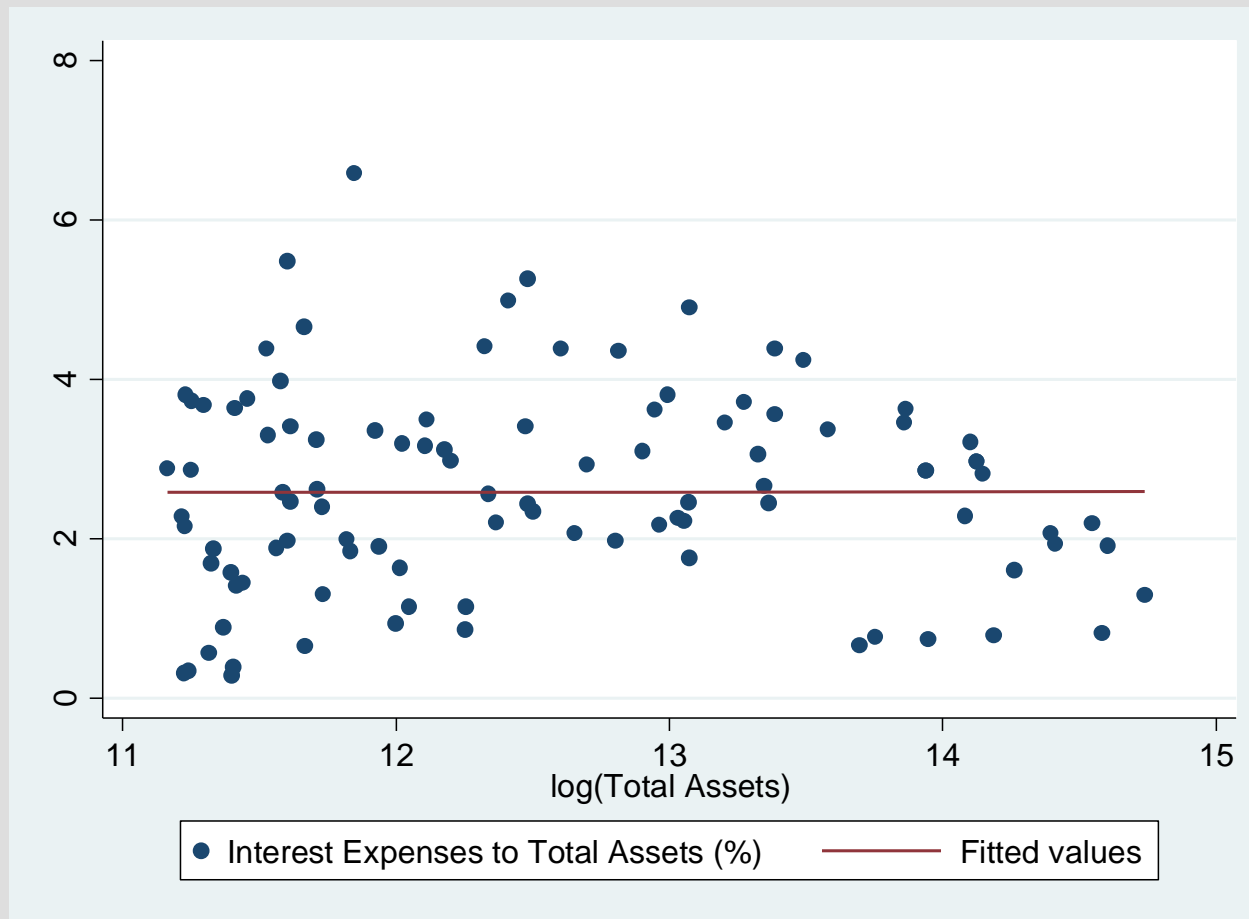
Source: Bankscope. Banks with assets above US\$ 25 billion. December 2008. 245 institutions from 38 countries.

Cost of funding vs size



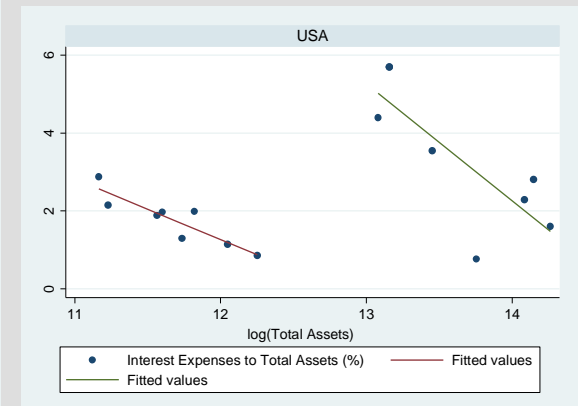
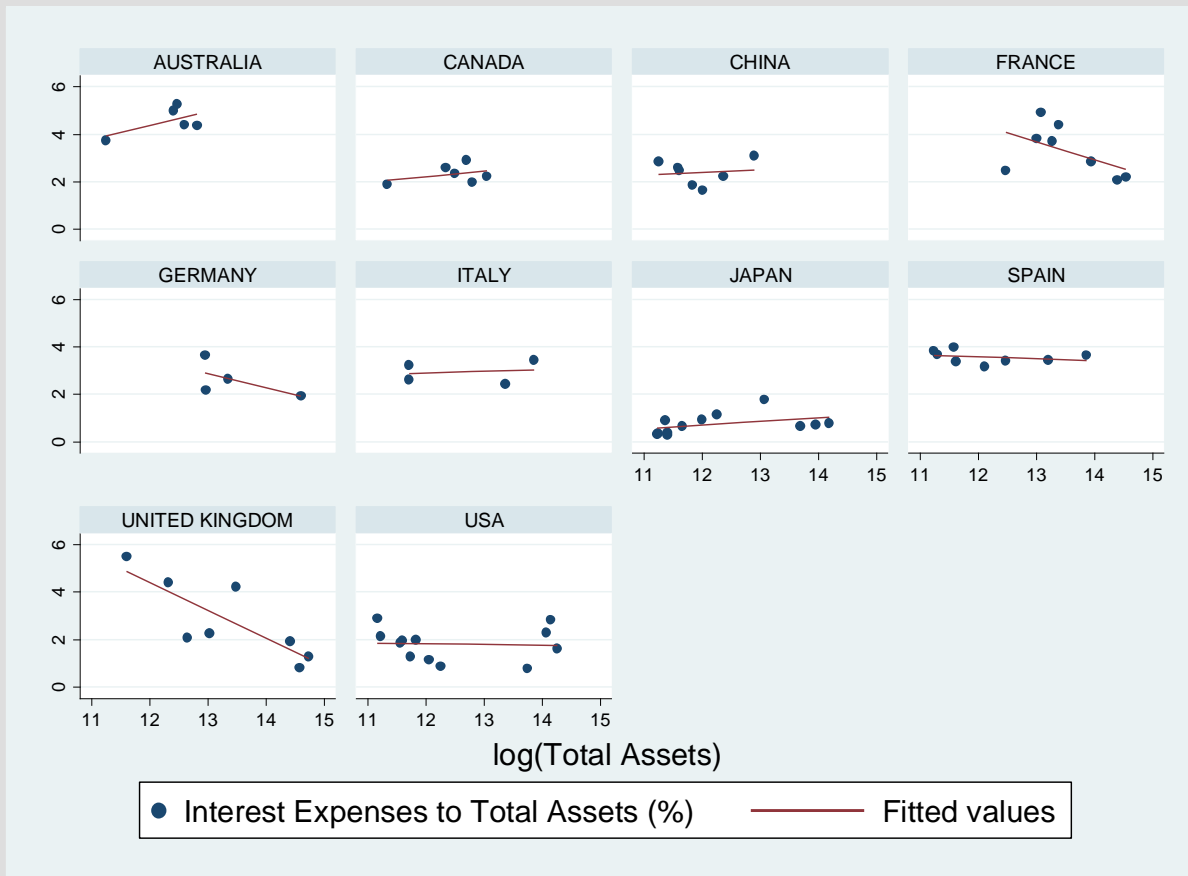
Source: Bankscope. Banks with assets above US\$ 25 billion. December 2008. Required at least 5 banks per country.

Cost of funding vs size



Source: Bankscope. Banks with assets above US\$ 100 billion. December 2008. 101 institutions from 22 countries

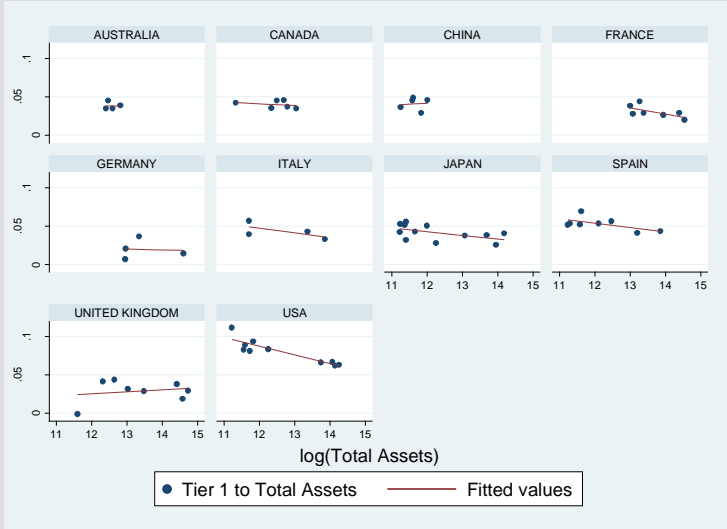
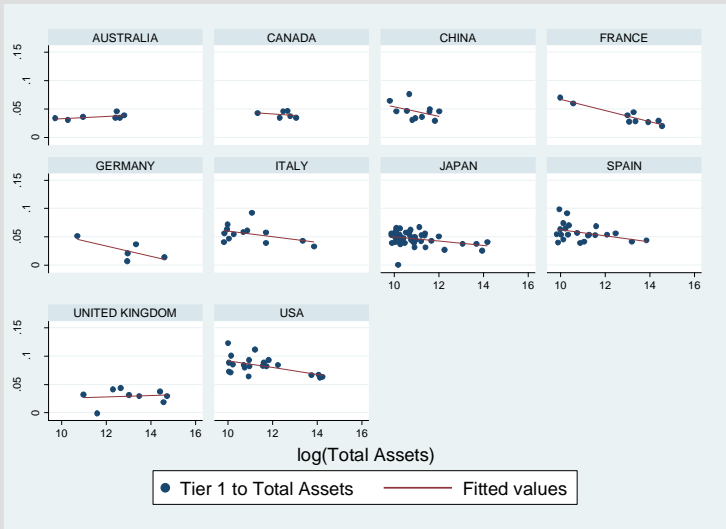
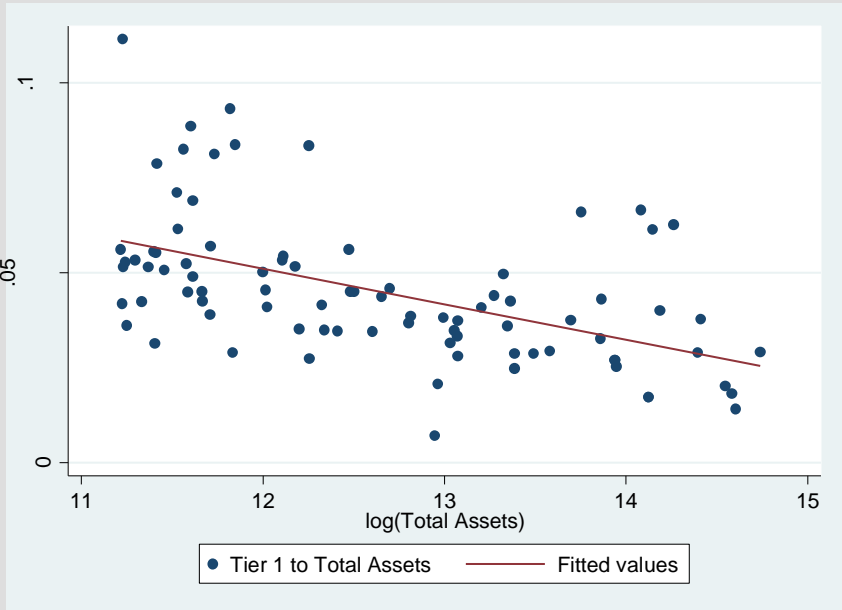
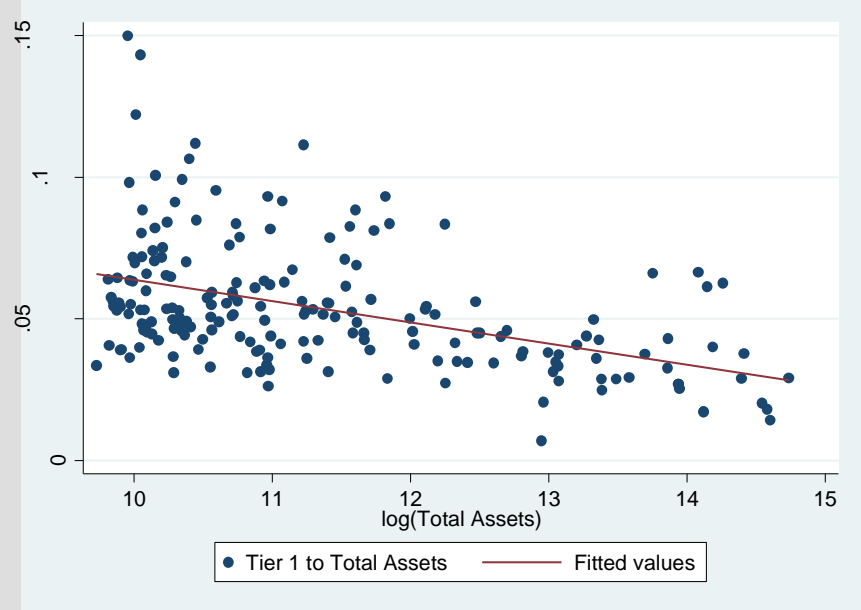
Cost of funding vs size



Source: Bankscope. Banks with assets above US\$ 100 billion. December 2008. Required at least 5 banks per country.

Tier 1 vs size

US\$ 25 billion (left) and US\$ 100 billion (right)



Definition of a systemic institution

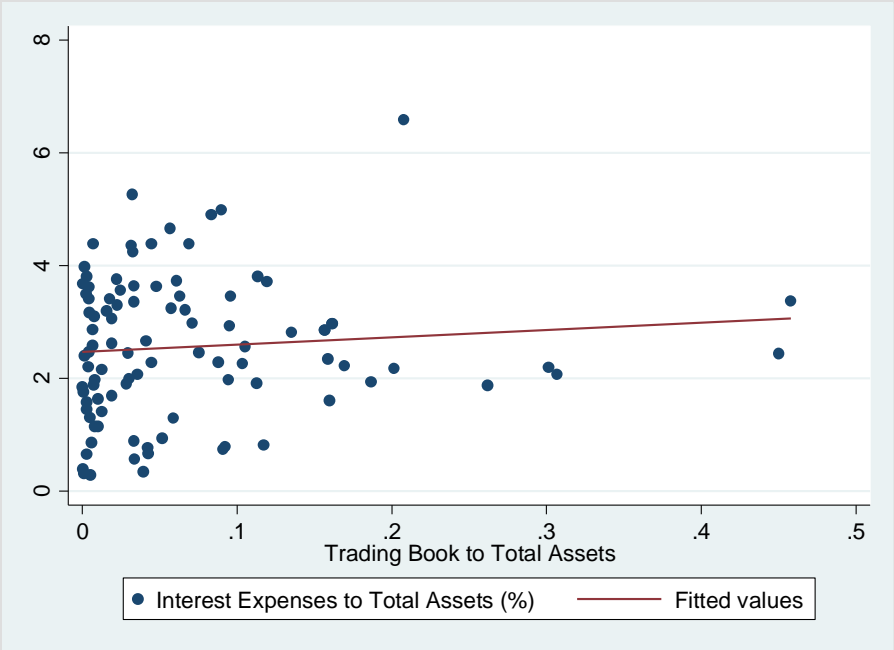
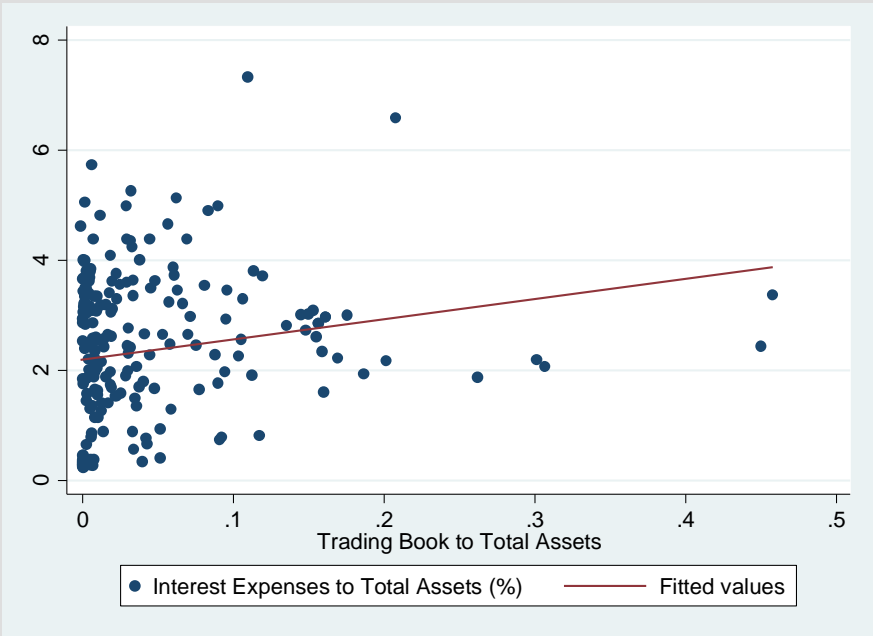


- Risk profile of a bank is a key driver
- Size of more volatile (e.g. trading book) portfolios?
- These portfolios are the most complex to value as well as substantially opaque
- Institutions holding these portfolios are the most interconnected and difficult to substitute in key opaque markets
- On the other hand, retail franchises with more traditional portfolios (less volatile, easier to calculate their expected losses and, thus, to provision) are much less risky
- Therefore, there is a set of banks that, given their business specialization, have a higher probability of triggering a systemic crisis. These should be our target

Cost of funding vs risk



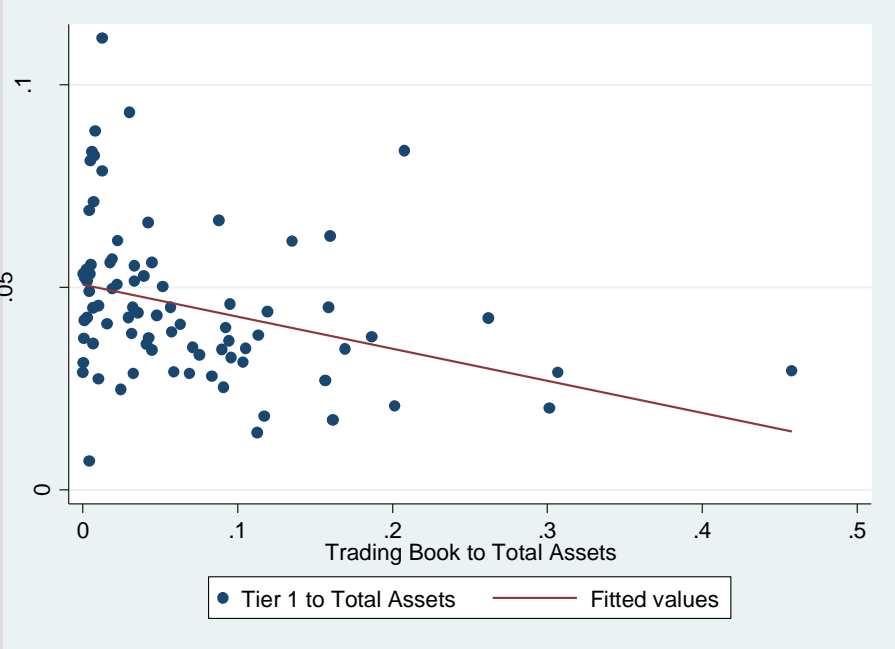
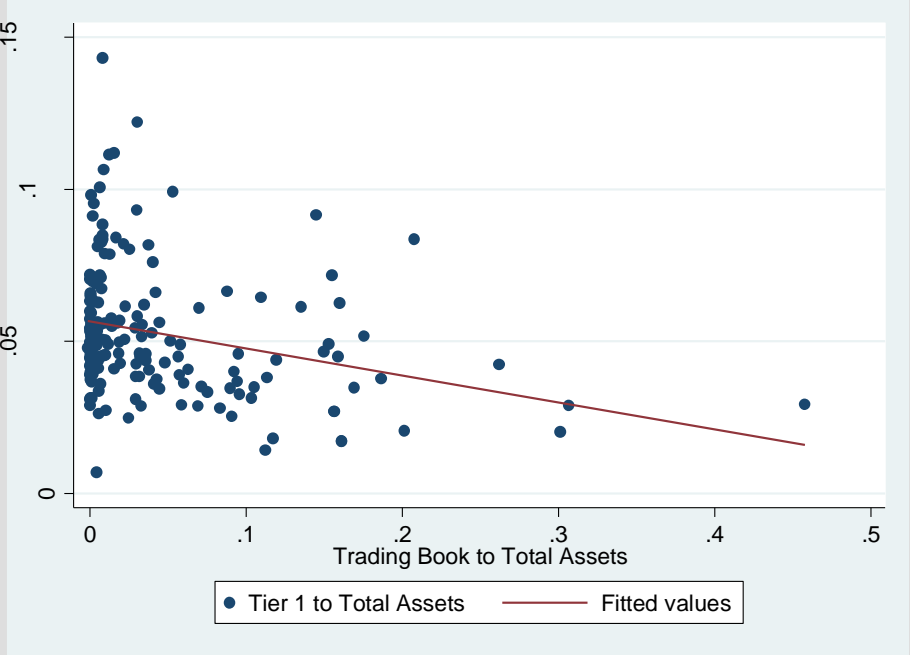
US\$ 25 billion (left) and US\$ 100 billion (right)



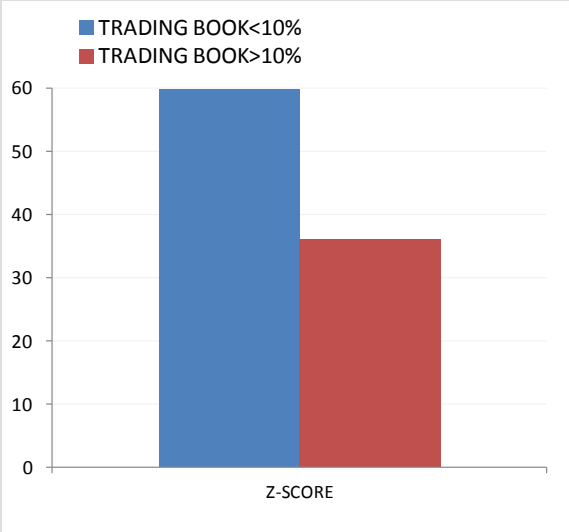
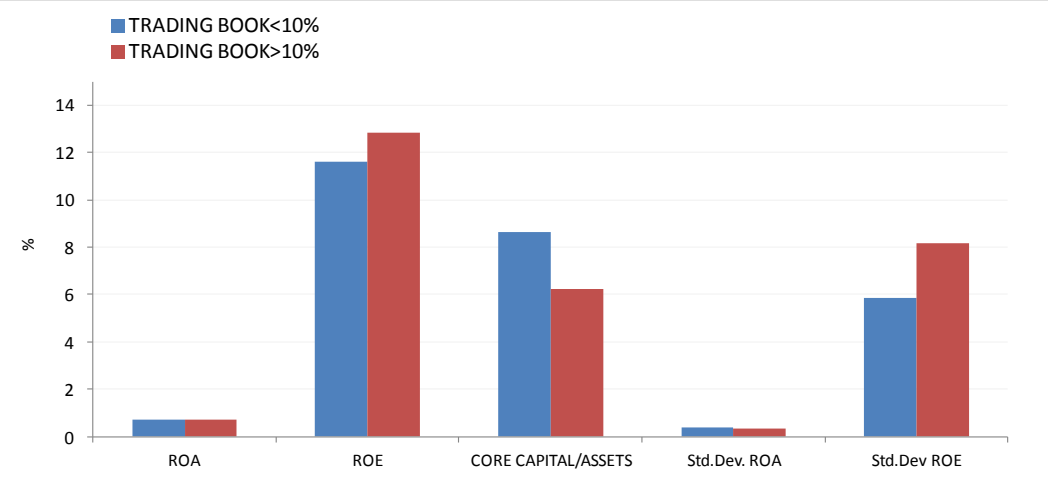
Cost of funding vs risk



US\$ 25 billion (left) and US\$ 100 billion (right)

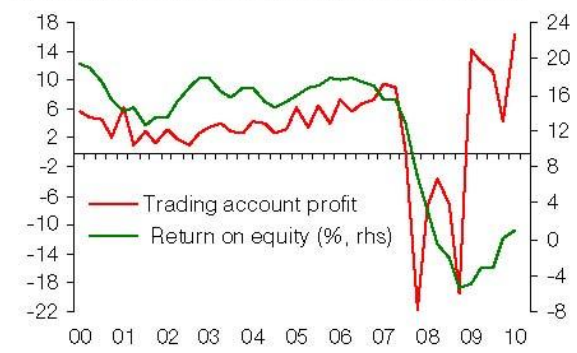


Risk vs business model



Large U.S. Banks: Trading account profit and ROE

Trading account profit (US\$ billions) and ROE (% , rhs)



Source: IIF

Definition of a systemic institution



- Bank structure and organization is also a key driver
- Cross border banking groups have different structures
- Resolution of troubled banks depends on their structure
 - A web of interconnected branches is much more difficult to resolve than a clear-cut structure of financially independent subsidiaries, each one with stand-alone capital and liquidity and clear ties with the parent bank
- Therefore, again, there is a set of banking institutions that given their structure are much more difficult to resolve than others with similar size

What to do with systemic institutions?



- First of all, it is important to acknowledge that it is difficult to measure systemic risk/institutions
- It is easy to take short cuts but with a high risk of missing the real target
- Do we want a public list of systemic institutions?
 - Such a list would be a moving target
 - If it is public it increases moral hazard as well as instability during crisis (flow of funds in and out)

What to do with systemic institutions?



- Therefore, it seems that the supervisor of each bank is the one that should determine whether the institution is systemic or not
 - Role for core college members
- In order to have a level playing field, we should also develop common guidelines
 - Common indicators
 - Harmonized across banking system
 - Subject to peer review

What to do with systemic institutions?



- Therefore, we support making the following tool box available to supervisors :
 - Improve risk management in systemic banks
 - Improve corporate governance in systemic banks
 - Improve micro supervision of systemic banks
 - Living wills:
 - *Recovery and resolution plans for each systemic institution*

What to do with systemic institutions?



- Specific prudential measures
 - *More capital and of a higher quality*
 - *Requirements based on a continuous function if a reasonable indicator is available (e.g. an array of variables)*
 - *Pillar 2 requirements + internationally agreed guidelines*
- Need for convergence in applying the measures
 - *Peer review by FSB of requirements on systemic institutions*

What to do with systemic institutions?



- Size cannot be the only variable used to identify systemic institutions
- Size of the trading book much better candidate if we were to pick only one variable
- More capital is not the only response
- Supervisors should be in charge, through Pillar 2 measures
 - Pillar 1 answers are really difficult to achieve given the difficulties in identifying an array of variables that proxy for a systemic institution
- It is a must to ensure level playing field in this issue
- Prudential response better than a tax

What to do with systemic institutions?



- Our position is consistent with our traditional supervisory approach:
 - Specific risk profile of each institution
 - Role of the institution in the banking system
 - Prudential answer bank by bank
 - *Improve risk management and internal controls*
 - *Pillar 2 requirements*
 - *Promote simple structures (e.g. subsidiaries) and financial autonomy*
 - *Intrusive supervision*
 - *Prudent regulation (i.e. dynamic provisions, consolidation of conduits/SIVs)*



- Our focus is systemic institutions (banks, in particular) because we are a highly “bancarized” country (like many others)
- However, it is worth thinking about other non-bank financial institutions that are systemic
 - **Group of Thirty January 2009 Report (Volcker)**
 - *Insurance companies, broker-dealers, MMMF, leveraged private pools of capital,...must have appropriate standards for capital, liquidity and risk management and a national prudential regulator*
- Systemic markets: highly concentrated and opaque markets
- Systemic instruments:
 - **Watch carefully financial innovation, without stifling it**
 - **Exponential growth is a warning signal, almost always**

Conclusions

- SIMIs is a really important regulatory policy issue that needs thorough analysis
- Careful with using size (i.e. total assets) as short cut
- It is important to pay attention to the riskiest portfolios of large, interconnected and difficult to substitute institutions
- Banks are only a part of the puzzle
- There are other non-bank financial institutions that may pose systemic risks, as well as some opaque and highly concentrated markets



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THANK YOU FOR YOUR ATTENTION

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