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

Caveat

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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

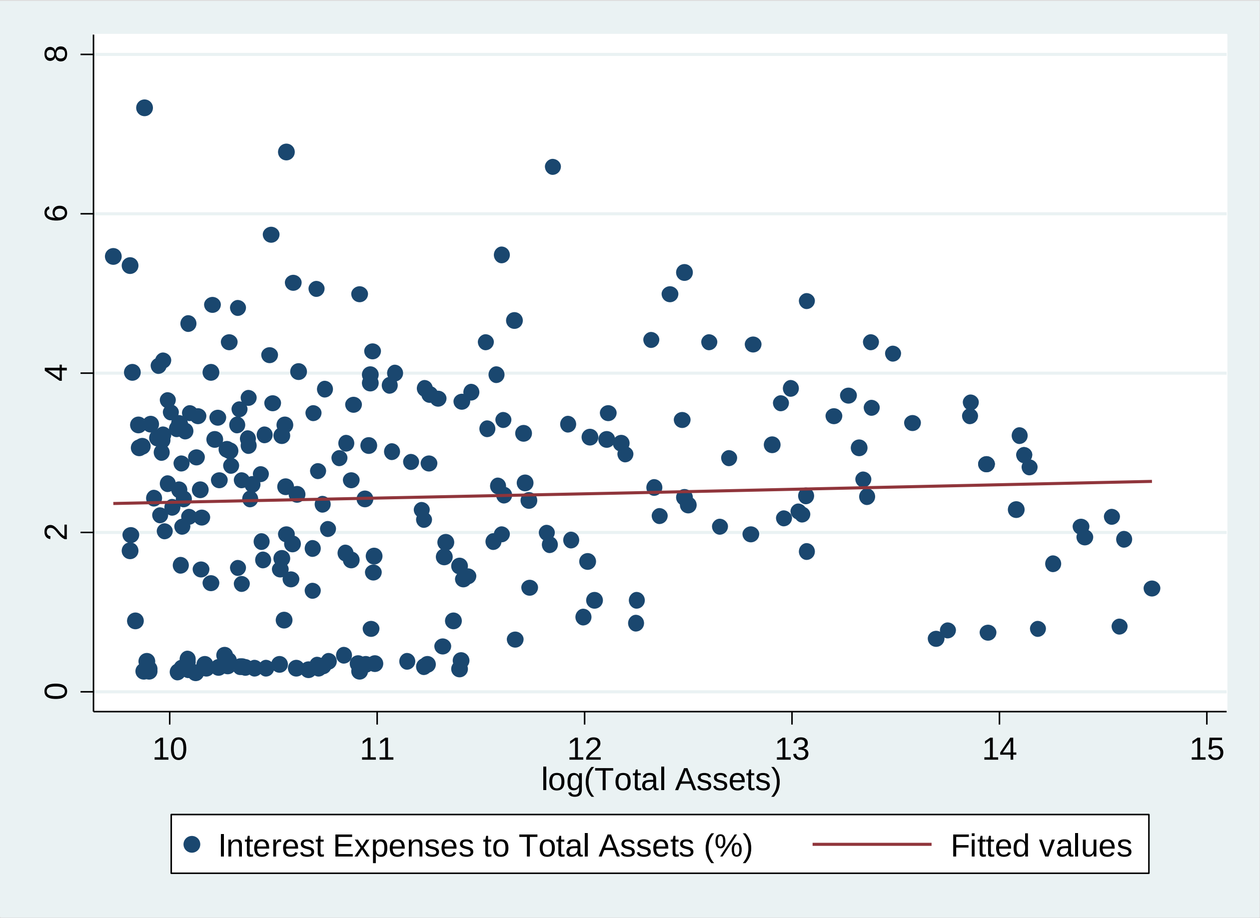
Crisis and systemic institutions

- 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

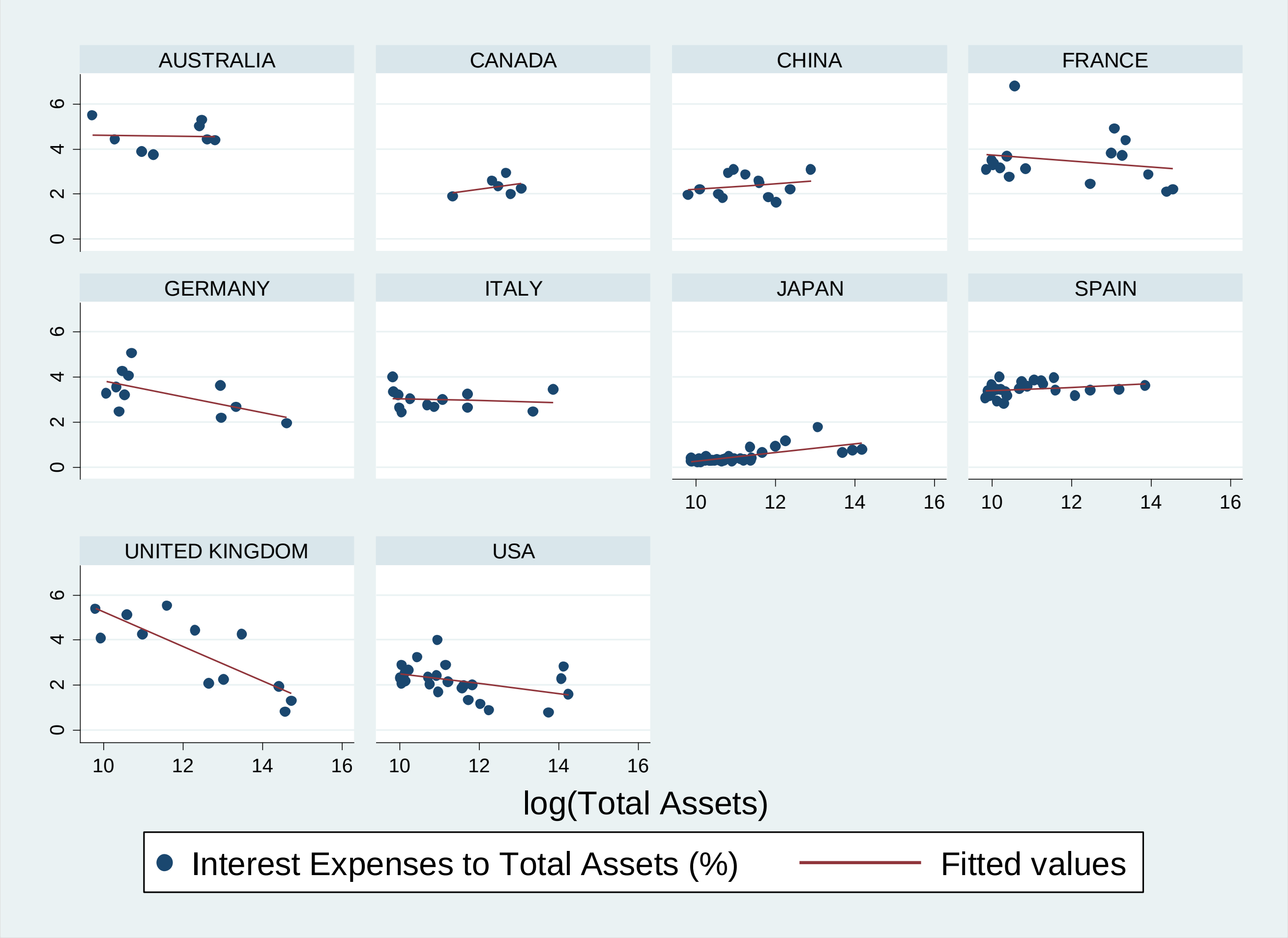
- Quick shortcut: size of the bank
- It seems clear that size is not the only driver of systemic risk, although it is the easiest one to measure
- Interconnections are also a key factor…
  - Repo transactions
  - Interbank loans
- …as well as lack of substitutability
  - Large concentration of few players 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



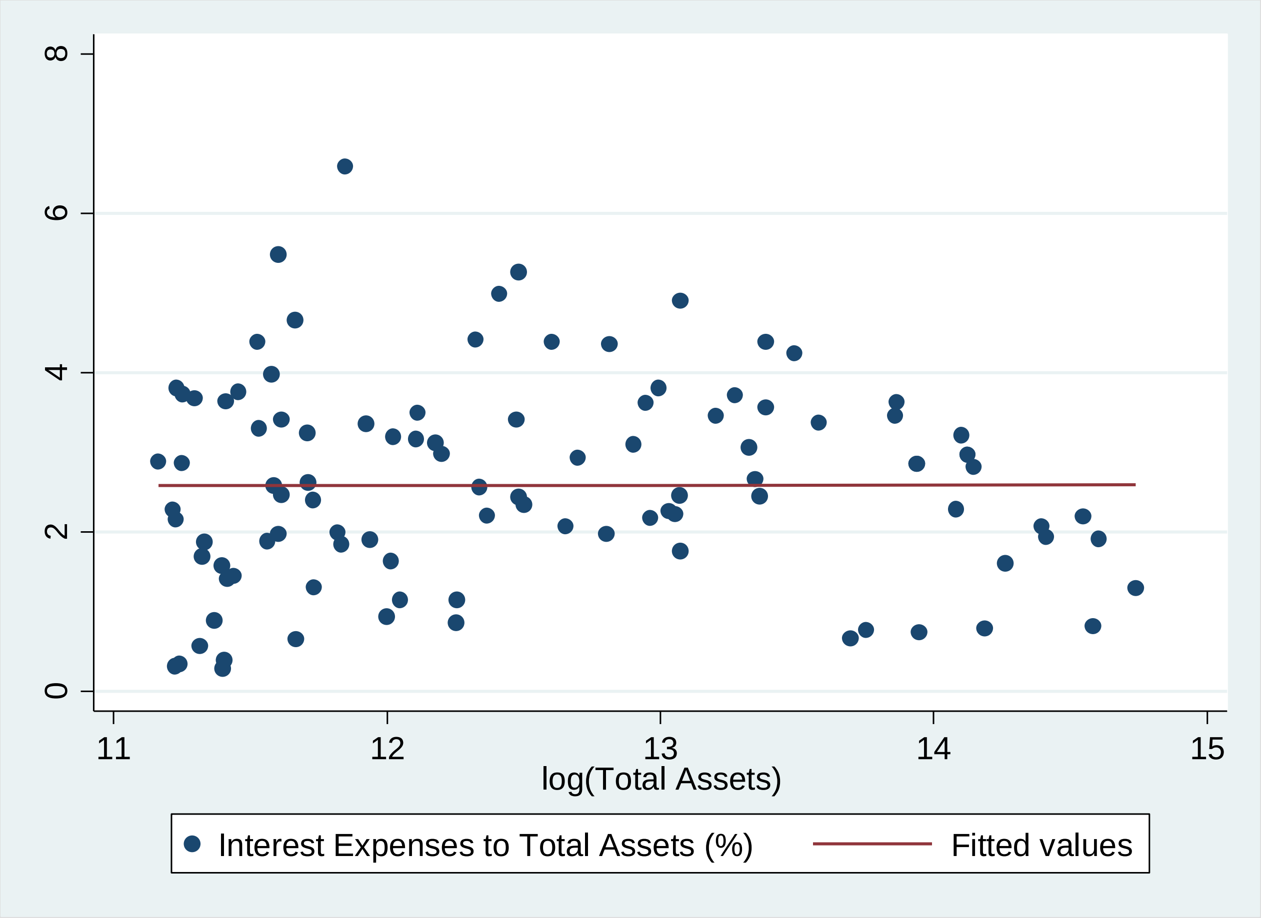
Source: Bankscope. Banks with assets above US$ 25 billion. December 2008. 245 institutions from 38 countries.

Cost of funding vs size



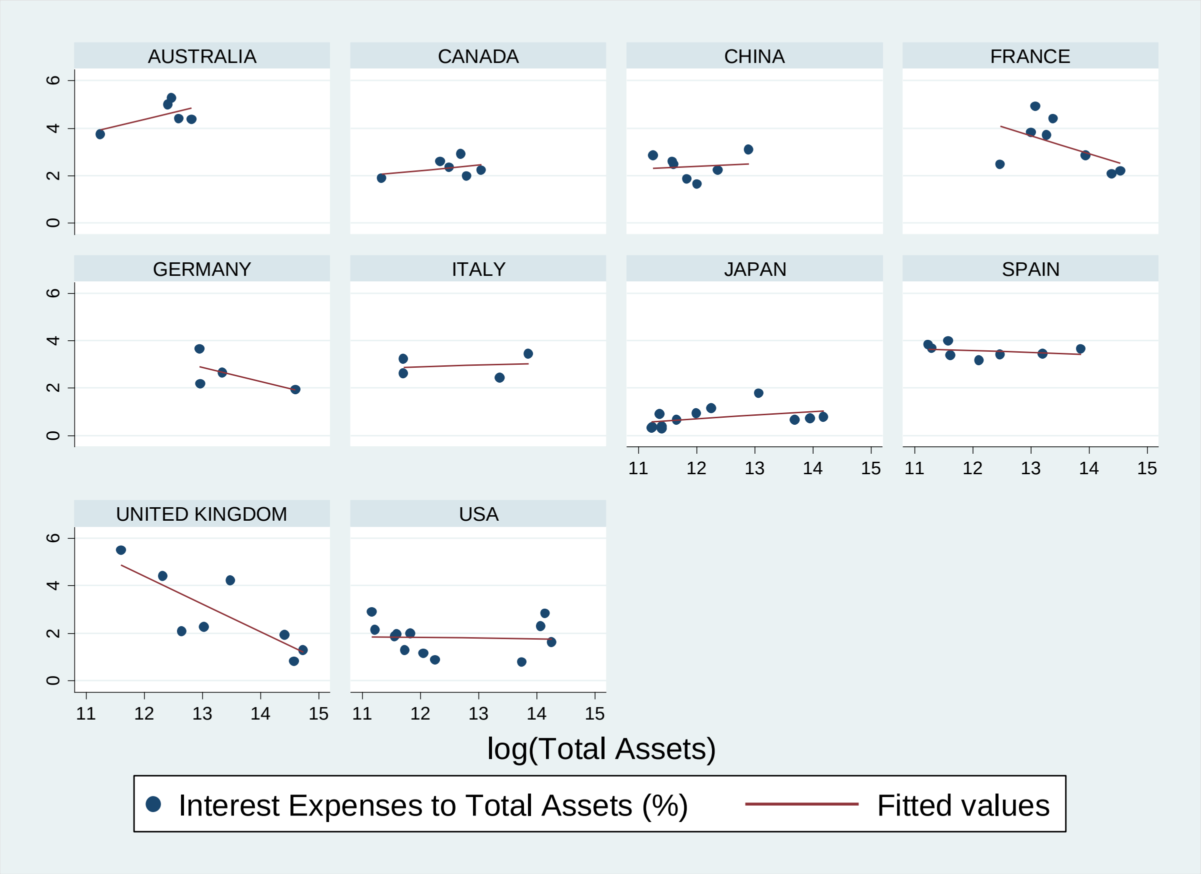
Source: Bankscope. Banks with assets above US$ 25 billion. December 2008. Required at least 5 banks per country.

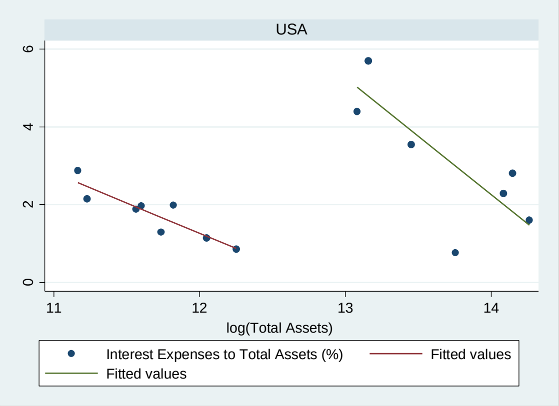
Cost of funding vs size



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

Cost of funding vs size

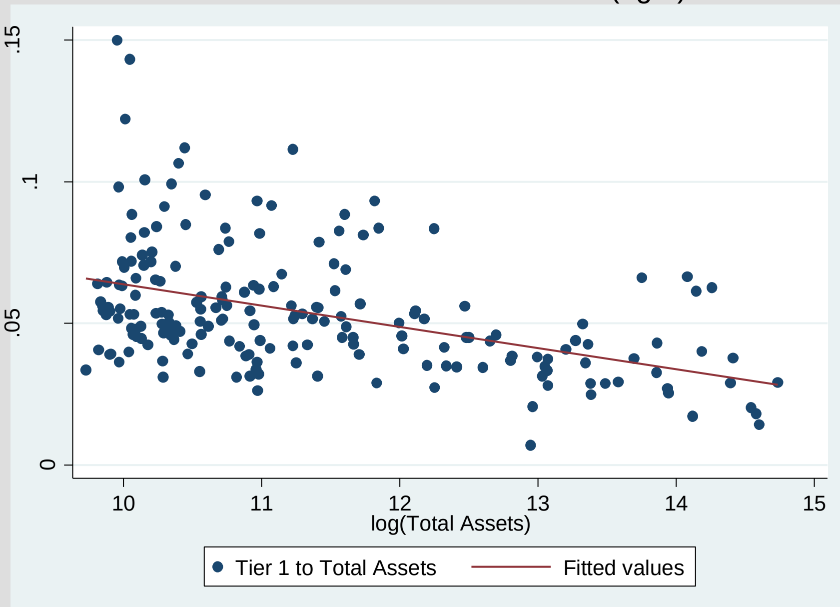


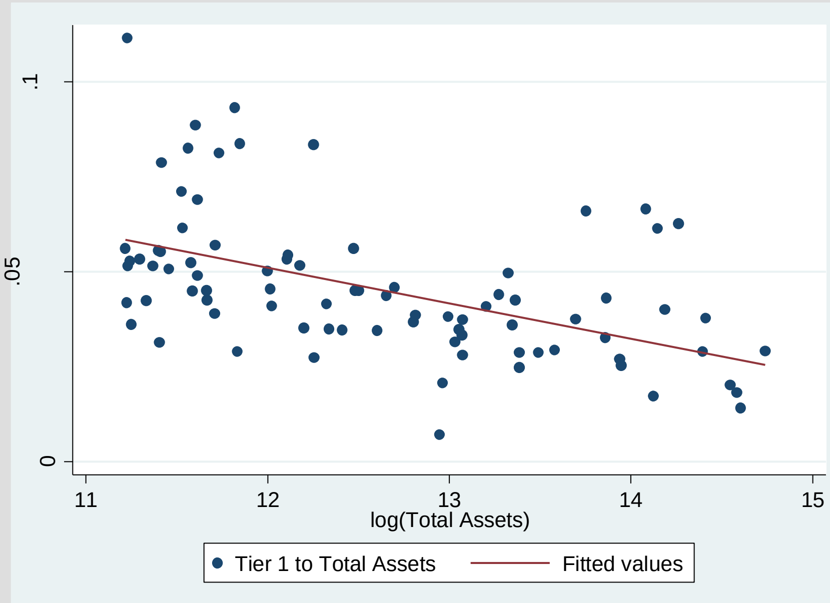


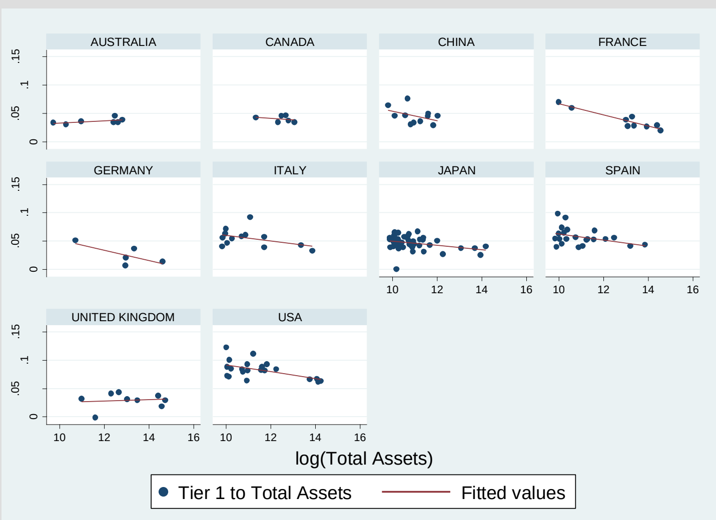
Source: Bankscope. Banks with assets above US$ 100 billion. December 2008. Required at least 5 banks per country.

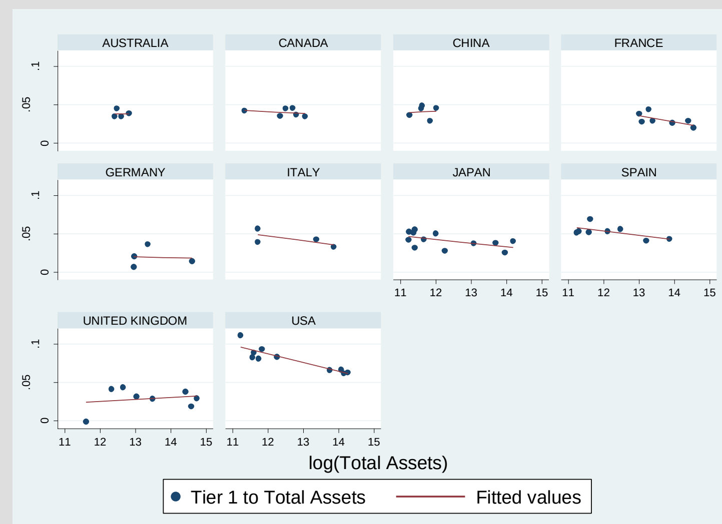
Tier 1 vs size

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







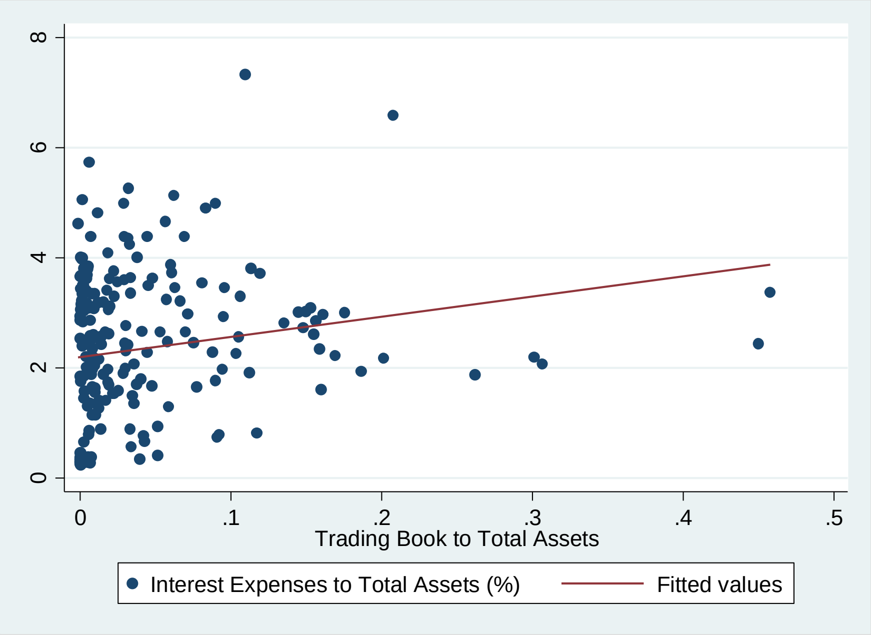


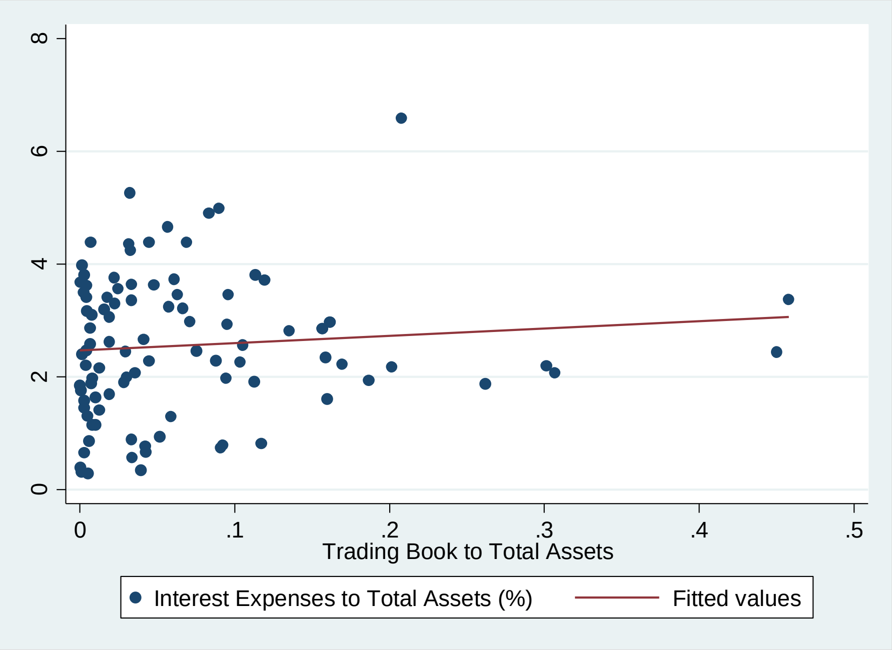
Definition of a systemic institution

- 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

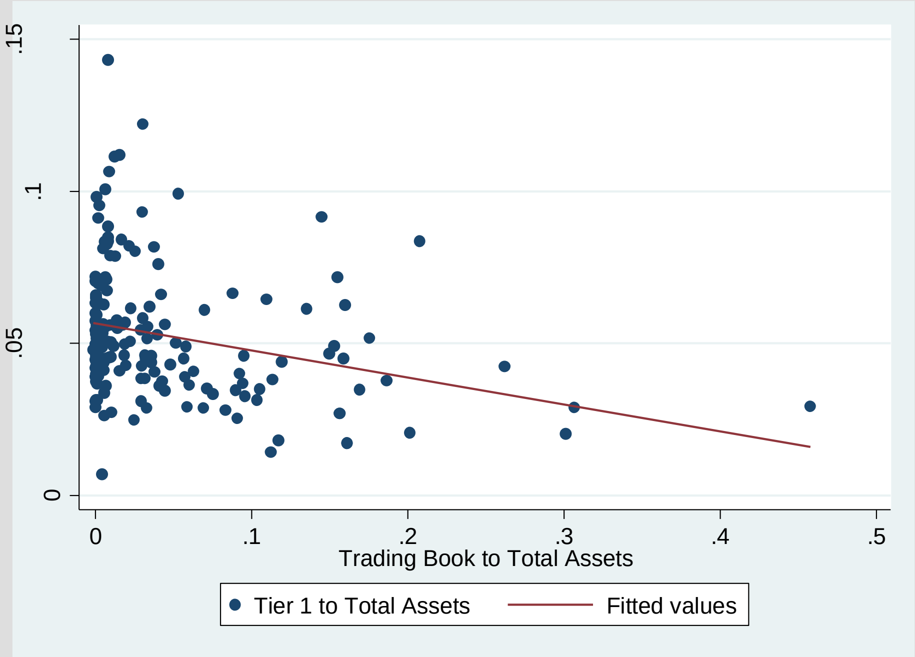
US$ 25 billion (left) and US$ 100 billion (right)

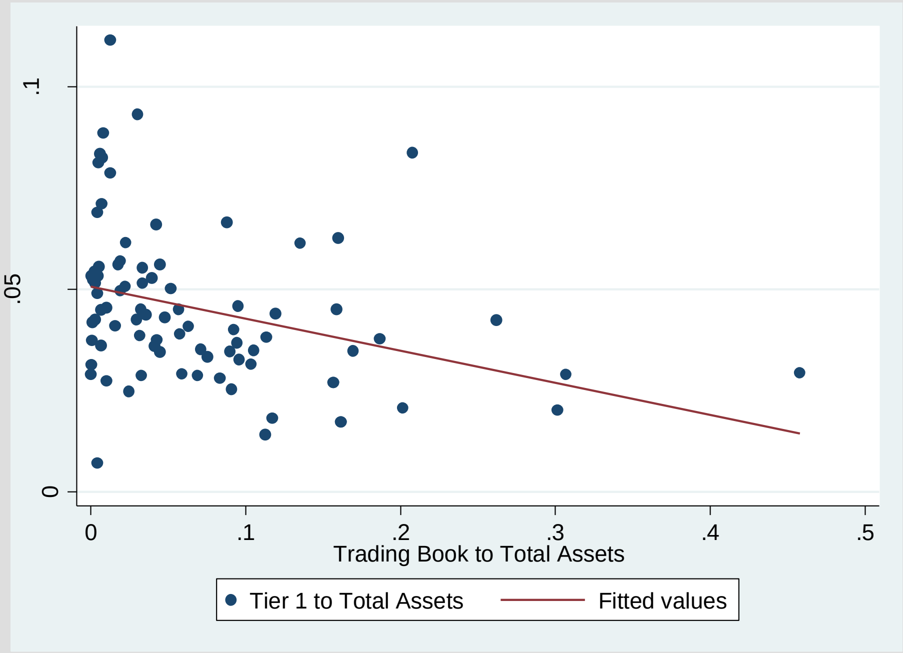




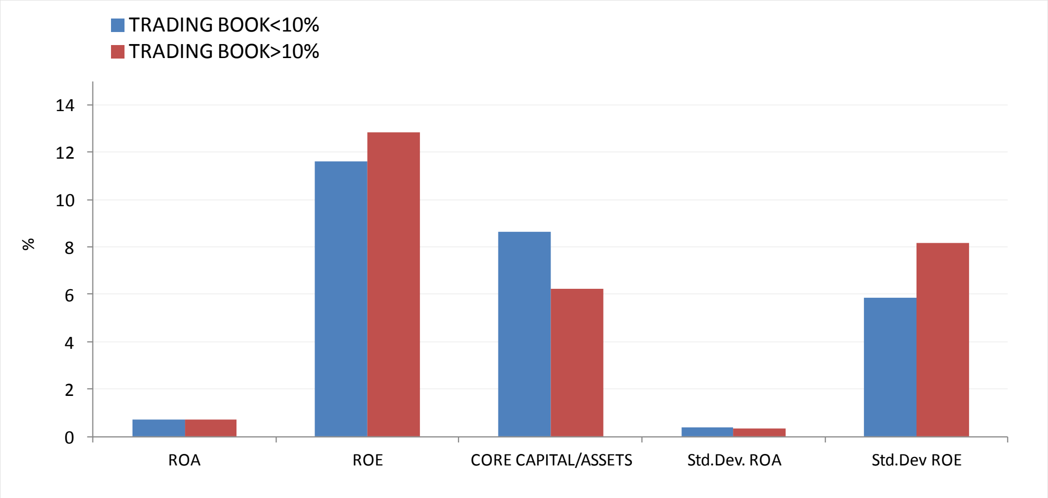
Cost of funding vs risk

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





Risk vs business model



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)*

SIMIs

- 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 concetrated markets

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THANK YOU FOR YOUR ATTENTION

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