

Yaseen Anwar: Managing Systemically Important Financial Institutions (SIFIs)

Speech by Mr Yaseen Anwar, Governor of the State Bank of Pakistan, at the second meeting of the Financial Stability Board (FSB) Regional Consultative Group for Asia, Kuala Lumpur, 14 May 2012.

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Ladies and gentlemen,

Good evening. It is indeed a pleasure to be here in Kuala Lumpur again, and I am grateful to Governor Zeti for inviting me as a lead discussant on one of the key challenges of regulatory reform agenda – “Managing Systemically Important Financial Institutions”. In these few minutes, I will cover the need for specific regulations for SIFIs, progress made so far in designing the policy framework, perspectives of emerging markets in general and Pakistan in particular, regulatory challenges faced by supervisory authorities, and what remains to be done.

In the aftermath of the Global Financial Crisis (GFC) 2007–08, the entire supervisory perspective towards financial institutions regulation has taken a U-turn. In the pre crisis era, supervisory authorities, mainly in advanced countries, chose to rely on market discipline and favored somewhat self regulation by the financial industry. The approach stemmed from the perception that financial institutions are in the best position to understand the market and risk associated with financial products. Overly prescriptive regulations were thought to stifle innovation and diversification – both across borders and across activities. The prevailing version of international accord on capital and liquidity standards, Basel II, further reinforced this practice. Most frameworks relied on banks’ own assessment of risks. However the GFC, particularly the collapse of Lehman Brothers in the fall of 2008, triggered problems throughout the financial system across the world and changed supervisory perspective towards financial industry regulations, particularly the so called “Systemically Important Financial institutions (SIFIS¹)”. The Lehman bankruptcy with ensuing financial instability and loss of real output brought forth several shortcomings of the international financial architecture that exposed risks resulting from a lack of a policy framework for dealing with SIFIs. In the pre-GFC era it was precisely these institutions that were deemed quite invincible. However, the huge costs of implicit government guarantees of not letting a SIFI to fail and their adverse impact on global financial stability, raised serious concerns on “Too Big to fail” (TBTF) status of SIFIs. Post crisis era witnesses increased discussion on changing TBTF status of SIFIs and for devising a resolution regime as well as safe exit mechanisms for these entities. Resultantly, immediately after the Lehman failure, we saw international financial authorities placing financial sector reforms as their top priority agenda.

Over the last few years, we have seen increased realization among financial authorities that diversification may be beneficial for a large bank against idiosyncratic risk, but similar patterns of diversification by many global banks across the world had actually contributed towards building up of systemic risk. Further, it has also been recognized that the prevailing regulatory framework and policies are not sufficient to address the “negative externalities” that large financial firms create. Supervisory authorities have arrived at a consensus that

¹ SIFI DEFINITION: An institution, market or instrument is considered systemically important if its failure or malfunction causes widespread distress, either as a direct impact or as a trigger for broader contagion. The interpretation, however, is nuanced in that some authorities focus on the impact on the financial system, while others consider the ultimate impact on the real economy as key (Financial Stability Board (2009)). Negative externalities are associated with institutions as they are perceived not being allowed to fail due to their *size, interconnectedness, complexity* key criterion to identify SIFIs.

SIFIs require enhanced supervisory focus on account of their relative size, interconnectedness with market(s) and complexity. To reduce the probability of failure of such institution and minimize the risk to financial stability and the real economy, it is imperative to strengthen the regulatory framework and enhance supervisory capacity for dealing with SIFIs.

Before expressing my views on the regulatory framework for SIFIs, I would like to appreciate the commendable work done and progress made by the FSB, BCBS and other multilateral agencies on the financial reforms agenda over the last few years. Enhanced international accord on capital and liquidity standards; i.e. BASEL III, has set forth the most critical reforms agenda for improving the solvency and resilience of financial institutions. A number of other policy measures supplement Basel III, which among others, included framework for dealing with global SIFIs (G-SIFIs). Starting from initial “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” issued in November, 2009 jointly by the IMF, FSB and BIS, substantial progress has been made in tackling the SIFIs challenge. A key development took place in November, 2011, when G-20 leaders at the Cannes Summit endorsed the policy framework on systemically important financial institutions (G-SIFIs). A multipronged strategy was adopted for addressing the G-SIFIs comprising of a new international standard for resolution regimes, more intensive and effective supervision, and requirements for cross-border cooperation and recovery and resolution planning.

One of the key issues concerning the SIFIs is their identification. The method used for identification of SIFIs varies widely – from complex models to simple indicators (see Box 1 for discussion on methods to identify SIFIs). To facilitate the process, FSB and BCBS have been assigned to determine the G-SIFIs to which the resolution planning and additional loss absorption requirements will apply based on the methodology developed by the BCBS. Accordingly, FSB and BCBS have identified 29 systemically important banks on a global level² out of a sample of 73 banks. These include 25 banks in the USA and Western European block, 3 in Japan and 1 in China. FSB will update the above list annually based on its assessment which will be publically disclosed.

Box 1: SIFIs can be identified either using model based approaches such as contribution, participation and bottom up approach or using a set of simple indicators such as bank size, interbank lending, interbank borrowing. A BIS article “Systemic Importance: Some Simple Indicators (2011)” empirically tested and found that simple indicators are reliable proxies for model-based measures of systemic importance. Alternatively FSB has proposed three key indicators for identifying SIFIs. These are size, interconnectedness and complexity. Whereas the five indicators used for designating Global-SIFIs by FSB are: size, interconnectedness, complexity, and substitutability and cross jurisdiction activity.

To address the greater risk posed by the G-SIFIs, intensive regulatory approach is being prescribed for them. They are required to meet the additional loss absorbency requirements ranging from 1% to 2.5% of Risk Weighted Assets (RWA). These requirements will be applicable in phases starting January 2016 with full implementation by January 2019. As per FSB and BCBS assessment, long term economic benefits in terms of greater resilience of these institutions from additional loss absorbency requirements far exceed the modest temporary decline of GDP over the implementation horizon.

Another positive development on this front is that some of the countries, notably Switzerland, United Kingdom and Sweden have already taken action to implement higher capital requirements for banks that are deemed systemically important at the national level. Recently, Financial Stability Oversight Council (FSOC) in the USA proposed guidance on the

² See Annexure 1 for a list of G-SIFIs by FSB

process and the factors that it will use to designate Non-Bank Financial Institutions as SIFIs. Some jurisdictions have already adopted legislation to improve their resolution regimes like Germany, where supervisory powers have been significantly extended to restructure and resolve banks. On the other hand, many institutions have actively lobbied against being identified as a SIFI, because of the additional and significant regulatory requirements that SIFIs will endure.

Emerging markets

Emerging economies financial systems remained fairly resilient in the face of recent crisis. It was possible firstly because financial systems in emerging economies have primarily domestically active FIs. This argument can be supported by the fact that out of 29 designated G-SIFIs³ only one bank from Asia; “the Bank of China” could make it on the list. Secondly, financial systems in emerging economies remain relatively conservative – activities are mainly centered on more traditional banking businesses while capital markets and other financial institutions remain relatively underdeveloped. The difference between financial structures and business models of developed and emerging economies have raised concerns regarding relevance of the reforms – which mainly addresses causes of GFC – for emerging economies. Moreover, since the Asian financial crisis of 1997–98, financial authorities have not only carried out extensive reforms but are very keen in continuously monitoring and adapting to the changing market conditions.

Nonetheless, it is a common understanding that supervisory authorities around the world need to give special attention to SIFIs by focusing on the development of specific, relevant and appropriate regulatory standards. In this regard, Asian economies are quite well aware of the issues involving implementation of such a framework. Firstly, emerging Asia is now at the center of global economic growth. To sustain such growth, the need for financial intermediation is also likely to increase. While there is a global consensus on the use of public funds for resolution of SIFIs as a last resort, there can also be circumstances in which use of public funds may be less costly to the economy than excessively “taxing” of the banking system. Asian economies must weigh the cost of new regulations on institutions, against the perceived benefits that those regulations have for the economy and society. Secondly, international standards must be customized according to Asian economies business models. The regulatory and supervisory regime must target well-defined risks that could have systemic implications.

Pakistan’s perspective on SIFIs

Pakistan is a small, open economy, with domestically an active financial sector. In terms of banking concentration, top 5 banks (all locally incorporated) account for 51% of industry assets; while foreign assets of the system are 10.4% of total assets. Moreover locally-incorporated banks and most foreign branches don’t have significant exposures to the complex financial assets that caused financial meltdown in the U.S. and Europe. Apart from the conservative financial structure, i.e. less risky assets on banks’ balance sheets, SBP has always required banks to meet higher capital and liquidity standards, exceeding international norms in several areas. More importantly, we have a strong legal framework, which has been tested for effectiveness during the last decade and a half. SBP has successfully restructured a number of banks successfully demonstrating the problem bank resolution regime. We already practice enhanced supervision of the most significant financial institutions, identified

³ 17 are from Europe, 8 from US and in Asia 3 from Japan and 1 from China. The initial sample of 73 banks include from Australia, Belgium, Brazil, Canada, China, France, Germany, India, Italy, Japan, Korea, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States.

by size. The supervisory framework includes quarterly reviews of individual banks for off-site surveillance, periodical and special on-site inspections and regular interactions with banks' aimed at reducing the probability of failure of these institutions. The multi-pronged strategy has proved quite effective so far. SBP has ensured that adequate safeguards are in place to limit the direct impact of external shocks. Not surprisingly, Pakistan's financial system withstood the global financial crisis reasonably well.

SBP is vigilant towards the changing market dynamics, both locally and abroad, and is already in the process of reviewing Pakistan's banking industry vis-a-vis Basel III capital and liquidity standards. Regarding dealing with SIFIs, high-frequent monitoring and more in-depth supervision are our main tools for dealing with large banks, which are essentially the so-called SIFIs for us. However, we are looking forward to the development of a framework to identify and deal with domestic SIFIs (D-SIFIs) by FSB, BIS, and IMF. Till such time the framework for global SIFIs may be a useful starting point for countries like ours for dealing with domestic SIFIs. In view of that, we have already initiated an assessment process. Recently, we have conducted an in-house study based on simple indicators approach to assess possibility of domestic SIFIs in Pakistan; our initial assessment suggests that banks with the largest market share in terms of assets – are the most systemically important banks. These findings endorse the earlier held belief regarding the significance of asset size in Pakistan's banking industry.

Regulatory challenges

There are multiple challenges faced by regulatory authorities to design and implement the framework for SIFIs identification, implementation and cross border resolution – to accelerate reforms of domestic resolution regimes and tools and of frameworks for cross-border enforcement of resolution actions. One of the major issues highlighted by the crisis has been gaps in the legal framework for dealing with failing financial institutions. Though capital buffers will help build up the resilience, however, it cannot avoid failures. Therefore gaps in legal frameworks must be addressed so that SIFIs, too, must be able to exit the market in an orderly manner without exposing taxpayers to the risk of loss.

Emerging economies need to be cautious while adopting the regulatory framework being proposed for SIFIs. A detailed assessment on the possible legal, regulatory and economic implications is imperative before adopting and customizing the SIFI regulatory framework to one's own financial structure. An important challenge for regulators is to develop a framework that allows financial sector to grow, innovate, and support the needs of the economy, without compromising on the stability of the financial system.

Nonetheless, an effective framework for dealing with SIFIs would include a combination of stronger market discipline; capital buffers; comprehensive recovery and resolution arrangements; and a strengthened market infrastructure to reduce probability of failure.

Going forward

In the near future we expect to see further developments in the areas of managing SIFIs, particularly the D-SIFIs. As highlighted above, FSB is already working with the Basel Committee for extending the framework to D-SIFIs. The selection criteria is expected to resemble that for the G-SIFIs, with institutions placed in different "buckets" according to their size, interconnectedness, and lack of substitutability. Once the framework is introduced in November this year, we expect to have detailed deliberation on implementation of the new framework in emerging and developing economies.

Development of a resolution regime will remain a key element of the D-SIFIs framework, making sure that the critical functions of these financial institutions continue in the event of failure. Given that it will involve legislative processes, the move towards development of a

resolution regime may be somewhat slow. Therefore, emerging markets and developing economies (EMDE), taking lead from the proposed framework for G-SIFIs, need to start work on the development of a resolution regime now rather than wait for a final D-SIFIs framework.

Another important issue for the emerging market economies from a stability perspective is on account of the presence of foreign financial institutions. The regulators of emerging markets may not be fully equipped to understand the risk profile of a globally active institution operating in their countries. Risks also arise due to financial interlinkages between emerging and foreign financial markets. For the host emerging economy, an important issue is possible market disruption through an adverse impact on local lending decisions and depositors safeguard as a result of problems at the parent institution level. Regulatory colleges should therefore be encouraged by the home regulators across the regions. The practice of conducting regulatory colleges for systemically important institutions would assist regulators in dealing with the global issues in a coordinated manner.

I would like to point out that regulation and monitoring of SIFIs is just one of the aspects in overall macro-prudential regulations. In order to implement a complete reform agenda, SIFIs framework needs to be dovetailed with other initiatives of financial stability. These may include an elaborate crisis management framework, work on countercyclical measures, framework for effective resolution of problem institutions, legal cover for enforcement etc.

Increased coordination among authorities both at top level as well as operational level is critical for successful implementation of a global financial agenda. For the purpose, there is a need to establish working committees under the Regional Consultative Group terms of reference. I therefore propose the establishment of working level committees to be involved in the development of policy level documents on financial stability related issues from the EMDEs perspective.

Thank you for your attention!

Annexure 1

The list 29 G-SIFIs is as follows:

U.S.	Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, J.P. Morgan (JPM), Morgan Stanley, State Street and Wells Fargo
U.K.	Royal Bank of Scotland, Lloyds Banking Group, Barclays, HSBC Holdings;
France:	Credit Agricole, BNP Paribas, Banque Populaire, Societe Generale
Germany:	Deutsche Bank, Commerzbank
Italy:	Unicredit Group
Switzerland:	UBS, Credit Suisse
Belgium:	Dexia
Netherlands:	ING Groep
Spain:	Banco Santander
Sweden:	Nordea
Japan:	Mitsubishi, Mizuho, Sumitomo Mitsui
China:	Bank of China

Chronology of developments regarding SIFIs, 30 April 2012

The report and background paper respond to a request made by the G20 Leaders in April 2009 to develop guidance for national authorities to assess the systemic importance of financial institutions, markets and instruments.

IMF, BIS, FSB, “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” (7 Nov 2009), available at <http://www.bis.org/publ/othp07.htm>

FSB Recommendations and Time Lines

FSB, “Reducing the moral hazard posed by systemically important financial institutions” (20 OCT 2010), available at http://www.financialstabilityboard.org/publications/r_101111a.pdf

A final framework issued by the Basel Committee on Banking Supervision for the additional capital required of G-SIFIs that are banks, or G-SIBs. The framework also includes the methodology for deciding which global banks will be considered G-SIBs.

BCBS, “Global systemically important banks: assessment methodology and the additional loss absorbency requirement – Rules text and Cover note” (Nov. 2011), available at <http://www.bis.org/publ/bcbs207.htm>.

A final policy framework for supervising SIFIs.

FSB, “Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision” (27 October 2011), available at http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

The list of the 29 global banking companies in the initial group of G-SIFIs.

FSB, “Annex to Policy Measures to Address Systemically Important Financial Institutions” (4 Nov. 2011), available at http://www.financialstabilityboard.org/publications/r_111104bb.pdf.

A final policy framework on resolution regimes (“Key Attributes”) that G20 countries are required to implement in order to resolve SIFIs effectively.

FSB, “Key Attributes of Effective Resolution Regimes for Financial Institutions” (4 Nov. 2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

Extending the G-SIFI Framework to domestic systemically important banks. The framework is still in development stages FSB, A Progress Report submitted to G-20 Ministers and Governors on 16 April 2012. http://www.financialstabilityboard.org/publications/r_120420b.pdf