

The Emerging Framework of Systemic Financial Risk

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Systemic Financial Risk

Agenda

- What do we mean by systemic financial risk?
- Dodd-Frank approach to tackling systemic risk
- Basel III approach to tackling systemic risk
- Potential issues with each construct
- Measuring impact of a financial institution's contribution to systemic risk
- Defining SIFIs
- The Financial Stability Board
- Managing risk at the individual institution level

Systemic Risk

What do we mean by systemic risk?

- “The risk of disruption to the flow of financial services that is (i) caused by the impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy” (The Financial Stability Board)
- “Fundamental to this definition is the notion that systemic risk is associated with negative externalities and/or market failure and that a financial institution’s failure or malfunction may impair the operation of the financial system or the real economy” (FSB)

Systemic Risk

- Two flavors
- Knock-on, or domino, risk
 - Failure of one institution triggers failures of other institutions due to credit exposure to the failing institution
- Panic
 - A failure or other event causes a loss of confidence in financial institutions or assets
 - Liquidity disappears
 - Asset prices decline due to lack of buyers triggering widespread failures that aggravate the loss of confidence

Domino Risk

“With regard to Continental Illinois, the regulators’ greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of \$100,000, with a total investment of almost \$6 billion. The FDIC determined that 66 of these banks, with total assets of almost \$5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more than \$12 billion had between 50 and 100 percent of their equity capital invested.”

FDIC, An Examination of the Banking Crises of the 1980s and Early 1990s, p.250

Panic

“The end is to stay the panic; and the advances should, if possible, stay the panic. And for this purpose there are two rules: First. That these loans should only be made at a very high rate of interest. This will operate as a heavy fine on unreasonable timidity, and will prevent the greatest number of applications by persons who do not require it. The rate should be raised early in the panic, so that the fine may be paid early; that no one may borrow out of idle precaution without paying well for it; that the Banking reserve may be protected as far as possible.”

Panic

“The amount of bad business in commercial countries is an infinitesimally small fraction of the whole business. That in a panic the bank, or banks, holding the ultimate reserve should refuse bad bills or bad securities will not make the panic really worse; the ‘unsound’ people are a feeble minority, and they are afraid even to look frightened for fear their unsoundness may be detected. The great majority, the majority to be protected, are the ‘sound’ people, the people who have good security to offer. If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security on what is then commonly pledged and easily convertible the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.”

Walter Bagehot, *Lombard Street*, 1873

Dodd-Frank Approach

Dodd-Frank Approach

- Increase capital as well as oversight and supervision
 - Collins amendment
 - Basel III
- Limit activities that are perceived as “risky”
 - Volcker Rule
 - Lincoln swaps pushout
- Oversight of “systemic” institutions
 - Resolve institutions to contain too-big-to-fail
- Oversight of systemic activities
- Oversight of payment, clearing and settlement

Overview

Systemic Designation

- Many of the most significant changes affect entities designated as systemically important
- Bank holding companies with total consolidated assets equal to or greater than \$50 billion will automatically be considered systemically important
- These may include non-U.S. institutions
- Otherwise, the Council will consider designating institutions that are systemically important (again, these may include institutions that are non-U.S. institutions)
 - Systemically significant entities will be subject to requirements relating to:
 - Credit exposure limits
 - Capital
 - Requirement to provide resolution plans, or living wills
 - Limitations on acquisition transactions

Systemically Important Institutions

Intermediate Holding Company

- Federal Reserve may require a systemically important nonbank financial company to establish an intermediary holding company
- Segregate financial from commercial activities
- Direct or indirect parent company must serve as source of strength

Not Systemically Important

- Insured depositories and bank holding companies that are not systemically important also will be subject to more stringent requirements, including those related to:
 - Regulatory capital
 - Section 23A modifications
 - If over \$10b in total consolidated assets, then required to risk committees will be required, and must conduct internal stress tests
 - Additional rule making to be adopted generally, including on source of strength
 - Enhanced supervision and enforcement

What are you?

Banking Entity

Over \$50b in TCA:

Systemically important
15-to-1 maximum leverage

Under \$15b in TCA:

Not subject to hybrid prohibition

Over \$10b in TCA:

Risk committee
Internal stress tests
Volcker Rule provisions

All Banks

- Regulatory capital requirements
- 23A/B restrictions
- Enhanced supervision and enforcement
- Lincoln (push-out) provisions

Nonbank Financial Company

Supervised

Subject to capital and other requirements
Impacted by Volcker Rule
Intermediate holding company
requirement?

Not Supervised

Not subject to the more onerous
restrictions associated with Dodd-Frank

All Nonbank Financial Companies

- Subject to Consumer Financial
Protection Bureau oversight
- May be subject to supervision by the
SEC or CFTC (depending on entity)
- Financial entity?

All

Subject to:

- Securitization restrictions
- Derivatives (unless a commercial
end user) requirements
- Mortgage provisions
- Corporate governance and
executive compensation provisions

Systemically Important (Bank and Nonbank) Entities

- Credit exposure limits
- Living wills
- Capital requirements
- Limitations on acquisitions

Regulatory Capital

Regulatory Capital

- Generally, the Act imposes more stringent regulatory capital requirements on financial institutions
 - Requires the Council to make recommendations to the Federal Reserve regarding the establishment of heightened prudential standards for risk-based capital, leverage, liquidity and contingent capital
- Requires that the Federal Reserve, on its own, or with recommendations from the Council, establish prudential standards for supervised nonbanks and for bank holding companies with total consolidated assets equal to or greater than \$50b (*these may include non-U.S. institutions*), that include:
 - risk-based capital requirements,
 - leverage limits,
 - liquidity requirements,
 - overall risk management requirements,
 - requirements for a resolution plan, and
 - concentration limits

Regulatory Capital

- The standards to be set by the Federal Reserve will include:
 - a contingent capital requirement,
 - enhanced public disclosures, and
 - short-term debt limits
- Includes other requirements, including:
 - a risk committee requirement
 - a stress test requirement
 - for bank holding companies or a supervised nonbank with total consolidated assets equal to or greater than \$50b a maximum debt-to-equity ratio of 15-to-1

Regulatory Capital

- Incorporates a revised Collins amendment
 - Requires the establishment of minimum leverage and risk-based capital requirements
 - Sets at the risk-based capital requirements and the Tier 1 to total assets standard applicable to insured depository institutions under the prompt corrective action provisions of the FDIA
 - No deduction for investment in bank subsidiaries
 - Sets current rates as a floor
 - Effect on accounting issues and risk weights is unclear
- Limits discretion in establishing Basel III requirements (U.S. can adopt more onerous standards, but cannot adopt laxer standards)

Regulatory Capital

- Raises the specter of additional capital requirements for activities that are determined to be risky
 - Derivatives, securitized products, financial guarantees, securities borrowing and lending and repos
 - Assets valued based on models
 - Concentrations of market share
- These requirements become effective upon implementing regulations, which are required within 18 months of the passage of the Act

Regulatory Capital

Effect on Hybrids

- As discussed earlier, does not permit the inclusion of trust preferred securities or other hybrid securities in the numerator of Tier 1, subject to limited exceptions
 - Mutual holding companies and thrift and bank holding companies with less than \$15b in total consolidated assets are not subject to this
 - **Intermediate U.S. holding companies of foreign banks have a five-year phase-in period**
 - For newly issued securities (hybrids issued after May 19, 2010), the requirement is retroactively effective
 - For bank holding companies and systemically important nonbank financial companies, phase-in for hybrids issued prior to May 19, 2010 will be phased in from January 2013 to January 2016

Regulatory Capital

Contingent Capital

- Within two years of enactment, the Council must present the results of a study on contingent capital that considers, among other things, an evaluation of:
 - the effect on safety and soundness of a contingent capital requirement,
 - the characteristics and amounts of contingent capital that should be required, and
 - the standards for a triggering requirement
- Following the study, the Council may make recommendations to the Federal Reserve to require a minimum amount

Oversight and Supervision

Oversight framework

- In order to eliminate opportunities for regulatory arbitrage and in order to assess overall systemic risks, the Act implements a number of significant changes to the oversight structure
- Creates the Financial Stability Oversight Council, which will identify risks to U.S. financial stability
- Creates various other agencies, including the Office of Financial Research within Treasury, the Bureau of Consumer Financial Protection within the Fed, the Office of National Insurance within the Treasury and the Office of Credit Rating Agencies within the SEC

Financial Stability Oversight Council

Creation of the Financial Stability Oversight Council (“Council”)

- §111 Dodd-Frank Act
- Chaired by the Secretary of the Treasury
- 10 Voting members: Treasury Secretary; the heads of the Federal Reserve, OCC, Bureau of Consumer Financial Protection, SEC, FDIC, CFTC, FHFA, and NCUA; and an independent member with insurance expertise
- 5 Non-voting members: the directors of the Office of Financial Research and the Federal Insurance Office; a state insurance commissioner, a state banking supervisor and a state securities commissioner

Financial Stability Oversight Council

- **Meetings:** The Council will meet quarterly or at the call of the Treasury Secretary or the majority of the members
- **Vote:** The Council's votes generally require simple majority; however, certain actions require a 2/3 vote including the affirmative vote of the Treasury Secretary

Enhanced Supervision and Prudential Standards

- Federal Reserve, on its own or at the Council's recommendation, must establish prudential standards for systemically important institutions that are more stringent than those applicable to non-systemically important NBFCs and BHCs
- To prevent or mitigate risk to U.S. financial stability that could arise from the material distress, failure or ongoing activities of these companies
- Council may also recommend heightened standards and safeguards for financial activities and practices if Council determines that their scope, size or interconnectedness could create or increase the risk of significant liquidity, credit or other problems (§120 Dodd-Frank Act)
- §115 and §165 Dodd-Frank Act

Prudential Standards

- Federal Reserve must establish more stringent prudential standards for:
 - Risk-based capital requirements
 - Leverage limits
 - Liquidity requirements
 - Overall risk management requirements
 - Resolution plan and credit exposure report requirements
 - Concentration limits
- Federal Reserve may establish more stringent prudential standards for:
 - A contingent capital requirement
 - Enhanced public disclosures
 - Short-term debt limits
 - Such other prudential standards as deemed appropriate by the Federal Reserve, on its own or based on the Council's recommendations

Considerations

- In prescribing or recommending more stringent prudential standards the Federal Reserve and the Council must take the following factors into consideration:
 - All factors considered by the Council in designating NBFCs as being systemically important (§113 Dodd-Frank Act)
 - Whether a company owns a depository institution
 - Non-financial activities and affiliations
 - Other criteria the Federal Reserves determines to be appropriate, including those recommended by the Council
- Tailored Application: Federal Reserve, on its own or on recommendation by the Council, may differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors => NOT one size fits all approach

Additional Requirements

In addition, Federal Reserve shall require the following (§165 Dodd-Frank Act):

- Establishment of a risk committee (including BHCs with \$10b-\$50b assets) for publicly traded companies
- Semi-annual stress tests (annually for BHCs with \$10b-\$50b assets). Federal Reserve will also conduct its own stress tests
- A maximum leverage ratio of 15:1 if Council determines that the company poses a “grave threat” to U.S. financial stability
- Inclusion of off-balance-sheet activities in computing capital requirements

Mitigation of Risk

- If Federal Reserve determines, and upon 2/3 affirmative vote of Council, that a systemically important institution poses a great threat to the U.S. financial stability it can
 - limit such company's ability to merge with, acquire, consolidate with, or otherwise become affiliated with another systemically important institution
 - restrict the company's ability to offer a financial product
 - require such company to terminate one or more activities, or
 - impose conditions on the manner in which such company conducts one or more activities (§121 Dodd-Frank Act)
- Federal Reserve may also require a systemically important institution to sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities, if other measures are deemed to be inadequate

Limit Activities

Systemic Activities or Practices

- §120 Dodd-Frank Act permits Council to recommend heightened prudential standards or safeguards for particular financial activities or practices conducted by any company that is regulated by a primary financial regulatory agency
- Council must determine that the conduct, scope, nature, size, scale, concentration, or interconnectedness of the financial activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among BHCs and NBFCs, financial markets of the U.S., or low-income, minority, or underserved communities
- Primary financial regulatory agency must impose Council's recommendations or explain to Council within 90 days, why the agency has not followed the recommendations

Volcker Rule

- The Volcker Rule provisions, named for former Federal Reserve Chairman Paul Volcker, are premised on the belief that speculative trading activities contributed in part to the financial crisis
- The Volcker Rule was changed and reshaped during the entire legislative process

Volcker Rule

Volcker prohibitions

- There are important distinctions made between the activities that may be conducted by banking entities and those that may be conducted by nonbank financial companies supervised by the Federal Reserve
 - Generally, a banking entity cannot engage in proprietary trading or own interest in or sponsor a hedge fund or a private equity
 - A “nonbank financial company supervised by the Federal Reserve” that engages in proprietary trading or fund activities will be subject to additional capital requirements and quantitative limits, to be established by rule.

Lincoln Provision
(*the “Swaps Pushout” Rule*)

Prohibition on Federal Assistance

- Notwithstanding any other provision of law (including regulations), no ***Federal assistance*** may be provided to any ***swaps entity*** with respect to any swap, security-based swap, or other activity of the swaps entity
- Clarifies that insured depository institutions may have affiliates that are swaps entities, so long as the institution is supervised by the Federal Reserve and complies with sections 23A/23B of FRA
- Originally added in the Senate bill, §716 was diluted in the conference report
 - Narrower definitions
 - Added certain exclusions

Key Terms

- Federal assistance
 - The use of any advances from any Federal Reserve credit facility or discount window that is not part of a program or facility with broad-based eligibility
 - FDIC insurance
 - Guarantees
 - In any case, for the purpose of—
 - Making any loan to, or purchasing any stock, equity interest, or debt obligation of, any swaps entity
 - Purchasing the assets of any swaps entity
 - Guaranteeing any loan or debt issuance of any swaps entity
 - Entering into any assistance arrangement (including tax breaks), loss sharing, or profit sharing with any swaps entity
- Swaps entity
 - Only swap dealers and major swap participants
 - Senate bill included exchanges and clearinghouses
 - Excludes insured depository institutions that are major swap participants

Exceptions to Prohibition

- Prohibition on Federal assistance does not apply to insured depository institutions that limit their swap activities to:
 - **Hedging** and other similar risk mitigating activities directly related to the insured depository institution's activities
 - Acting as a swaps entity for swaps involving **rates** or **reference assets that are permissible for investment by national banks**
 - CDS is permissible only if cleared
- Insured depository institutions still must comply with proprietary trading ban under the Volcker Rule

Lincoln Provision (Swap Pushout Rule)

What Does §716 Really Accomplish?

- On the exceptions to the prohibition
 - Council may prohibit Federal assistance to swaps entities on an institution-by-institution basis upon a 2/3 vote
 - *Basis for determination* – When other provisions established by Dodd-Frank Act are insufficient to effectively mitigate systemic risk and protect taxpayers
- On the “prohibition against Federal government bailouts of swaps entities”
 - For purposes of § 716, the term “swaps entity” excludes any insured depository institution or covered financial company (large BHCs and nonbank financial companies supervised by the Federal Reserve) that is in conservatorship, receivership, or a bridge bank operated by the FDIC

Resolution Authority

Resolution Authority

- OLA framework:
 - Entity must be a “financial company”
 - There must be an FDIC and FRB recommendation (or request of UST) that the entity is eligible for receivership/liquidation under OLA
 - FDIC receivership
 - FDIC must ensure that its actions are necessary for the financial stability of the United States
 - Grants broad receivership powers to the FDIC

Identifying Institutions

Systemically Important Institutions

- Bank holding companies (“BHCs”) with total consolidated assets of at least \$50b (no designation) (§115 and §165 Dodd-Frank Act)
- Nonbank financial companies designated by the Council as being systemically important (regardless of size) (§113 Dodd-Frank Act)
- BHCs with at least \$50b in assets as of January 1, 2010 that (i) ceased to be a BHC after this date and (ii) received financial assistance under the TARP Capital Purchase Program, will be treated as being systemically important (§117 Dodd-Frank Act)

Nonbank Financial Companies

Nonbank Financial Companies (“NBFC”) (§102 Dodd-Frank Act)

- NBFC: any company, other than a BHC, that is predominantly engaged in financial activities
- Predominantly engaged in financial activities: 85% or more annual gross revenues or consolidated assets must be attributable to financial activities
- Financial activities: activities that are financial in nature according to Section 4(k) BHC Act and ownership or control of one or more insured depository institutions

Exclusion

The definition of NBFC explicitly excludes the following:

- National securities exchanges (or parent)
- Clearing agencies (or parent, unless it's a BHC)
- Security-based swap execution facilities
- Registered security-based swap data depositories
- Boards of trade designated as a contract market (or parent)
- Derivatives clearing organizations (or parent, unless it's a BHC)
- Swap execution facilities
- Registered swap data repositories
- Farm credit institutions

Systemically Important NBFCs

- Designation of an NBFC as systemically important must be done by a 2/3 vote of the Council including affirmative vote of the Treasury Secretary
- Designation must be reevaluated annually and can be rescinded upon a 2/3 vote of the Council including affirmative vote of the Treasury Secretary
- Council must determine whether material distress at the NBFC or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities could pose a threat to U.S. financial stability
- §113 Dodd-Frank Act

Systemically Important NBFCs

- Council must consider the following factors (§113 Dodd-Frank Act):
 - Extent of leverage of the company
 - Extent and nature of the off-balance sheet exposures of the company
 - Extent and nature of the transactions and relationships of the company with other significant NBFCs and significant bank holding companies
 - Importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the U.S. financial system
 - Importance of the company as a source of credit for low-income, minority, and underserved communities, and the impact that failure of such company would have on the availability of credit in such communities
 - Extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse
 - Nature, scope, size, scale, concentration, interconnectedness, and mix of activities of the company
 - Degree to which the company is already regulated by one or more primary functional regulatory agencies
 - Amount and nature of the financial assets of the company
 - Amount and type of liabilities of the company, including the degree of reliance on short-term funding
 - Any other risk-related factors that the Council deems appropriate

Notice and Review

- Council must provide NBFC with a notice of the proposed designation including an explanation of the basis of such designation
- NBFC may request a hearing within 30 days after receiving the notice
- Hearing must take place within 30 days of the request and Council must make a final decision within 60 days after the hearing
- NBFC may request judicial review in U.S. District Court within 30 days after receipt of the Council's final decision. Review is conducted under the "arbitrary and capricious" standard
- Emergency Exception: Council, by a 2/3 vote including the affirmative vote of the Treasury Secretary, may shorten NBFC's period to request a hearing to 10 days. Council must inform NBFC about such decision within 24 hours. A hearing, if requested, must take place within 15 days. Council's final decision is subject to judicial review
- §113 Dodd-Frank Act

Intermediate Holding Company

- Federal Reserve may require an NBFC designated as systemically important (or such NBFC may choose) to establish an intermediate holding company in which all financial activities are conducted
- Only the intermediate holding company with its financial activities will be subject to Federal Reserve supervision and prudential standards
- The direct or indirect parent company must serve as a source of strength to the intermediate holding company and is subject to limited reporting requirements to the Federal Reserve
- §167 Dodd-Frank Act

Foreign Financial Institutions

- Council must consult with the appropriate foreign regulatory authorities to the extent appropriate in exercising its systemic oversight authority with respect to foreign nonbank financial companies, foreign-based BHCs and cross-border activities and markets
- Foreign banks that own a U.S. bank are BHCs
- Foreign banks that maintain a U.S. branch or agency or commercial lending subsidiary are treated as BHCs
- Unclear whether only U.S. assets considered for the \$50bn asset threshold
- Council can designate a foreign NBFC as systemically important, regardless of size of U.S. operations => Council has to consider similar factors as for the designation of U.S. NBFCs, with a focus on U.S.-related assets, activities, and operations
- §113 Dodd-Frank Act

Anti-evasion

- Council may determine, on its own or upon request by the Federal Reserve, that the financial activities of a company that is not an NBFC should be treated like a systemically important NBFC (§113 Dodd-Frank Act)
- Determination must be made with a 2/3 vote including the affirmative vote of the Treasury Secretary
- Council must find that (i) the material distress related to, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the financial activities conducted directly or indirectly by a U.S. company or a foreign company with U.S. activities would pose a threat to U.S. financial stability, and (ii) such company is organized or operates in such a manner as to evade the application of the systemic risk regime under the Dodd-Frank Act
- Council must consider the same factors as for the designation of NBFCs, and the notice and review procedure is identical to the one applicable for NBFCs
- Financial activities: activities that are financial in nature according to Section 4(k) of the BHC Act and ownership or control of one or more insured depository institutions; does not include internal financial activities conducted for the company or an affiliate (including internal treasury, investment, and employee benefit functions)

Payment, Clearing & Settlement

Payment, clearing & settlement

- Designed to address systemic risk
- Payment and clearing transmits shocks through the financial system
- Payment, clearing and settlement utilities can reduce risk
 - Utilities also can concentrate risk
- Supervision of utilities first raised in FIDICIA in 1991

Payment, clearing & settlement

- Title VIII Dodd-Frank Act
- Council can designate important payment, clearing and settlement activities (“designated activities”) carried out by financial institutions and financial market utilities (“FMUs”) engaged in such activities as being, or likely to become, systemically important (§804 Dodd-Frank Act)
- Designation must be made by a 2/3 vote including an affirmative vote of the Treasury Secretary
- Rescission of designation also requires a 2/3 vote by Council including an affirmative vote of the Treasury Secretary
- Systemically important means a situation where the failure of or a disruption to the functioning of an FMU or the conduct of a designated activity could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threatening the stability of the U.S. financial system

Designated Activities

- “Payment, clearing, or settlement activity” means an activity carried out by one or more financial institutions to facilitate the completion of “financial transactions”
- Does not include any offer or sale of a security under the Securities Act of 1933, or any quotation, order entry, negotiation, or other pre-trade activity or execution activity
- Financial transactions are (§803 Dodd-Frank Act):
 - Funds transfers
 - Securities contracts
 - Contracts of sale of a commodity for future delivery
 - Forward contracts
 - Repurchase agreements
 - Swaps
 - Security-based swaps
 - Swap agreements
 - Security-based swap agreements
 - Foreign exchange contracts
 - Any similar transaction that the Council determines to be a financial transaction

Included Activities

When conducted with respect to a “financial transaction” designated activities (*i.e.* payment, clearing, and settlement) may include (§803 Dodd-Frank Act):

- Calculation and communication of unsettled financial transactions between counterparties
- Netting of transactions
- Provision and maintenance of trade, contract, or instrument information
- Management of risks and activities associated with continuing financial transactions
- Transmittal of storage of payment instructions
- Movement of funds
- Final settlement of financial transactions
- Other similar functions that the Council may determine
- The public reporting of swap transaction data under the Dodd-Frank Act is excluded

Systemically Important

In determining whether an FMU or a designated activity is, or is likely to become, systemically important the Council has to consider the following factors (§804 Dodd-Frank Act):

- The aggregate monetary value of transactions processed by the FMU or carried out through the designated activity
- The aggregate exposure of the FMU or a financial institution engaged in a designated activity to counterparties
- The relationship, interdependencies, or other interactions of the FMU or the designated activity with other FMUs or designated activities
- The effect that the failure of or a disruption to the FMU or the designated activity would have on critical markets, financial institutions, or the broader financial system
- Any other factors that the Council deems appropriate

Notice and Review

- Prior to making a designation, Council must consult with the Federal Reserve
- Council must give advance notice to the FMU or the financial institution that is carrying out the designated activity and must publish such notice in the Federal Register
- FMU or the respective financial institution may request a written or oral hearing within 30 days after receiving the notice, which must take place within 30 days after receiving the request
- Council must make final decision within 60 days after the hearing or, if no hearing was requested, within 30 days after the period for requesting a hearing has expired
- Emergency exception: notice and hearing requirement may be waived if Council deems it necessary with a 2/3 vote including an affirmative vote of the Treasury Secretary
- No specific provision for a judicial review, as there is for NBFC designation

Standards

- The Federal Reserve will prescribe risk management standards governing (a) the operations related to designated activities of an FMU that is systemically important, and (b) the conduct of designated activities by financial institutions
- CFTC and the SEC may prescribe similar risk management standards for clearing entities and financial institutions engaged in designated activities for which they have primary jurisdiction
- §805 Dodd-Frank Act

Objects & Principles, Areas

- Objects and principles of such standards shall be:
 - Promote robust risk management
 - Promote safety and soundness
 - Reduce systemic risk
 - Support the stability of the broader financial system
- Standards may address the following areas:
 - Risk management policies and procedures
 - Margin and collateral requirements
 - Participant or counterparty default policies and procedures
 - Ability to complete timely clearing and settlement of financial transactions
 - Capital and financial resource requirements for designated FMUs
 - Other areas that are necessary to achieve the objects and principles
- §805 Dodd-Frank Act

Basel III Approach to Systemic Risk

Basel III approach

- Increase capital and improve quality of capital; bail-in capital and contingent capital
- Impose a capital conservation buffer and a countercyclical buffer
- Discourage overreliance on leverage and impose new leverage ratio and liquidity ratios
- Promote use of various market tools and promote transparency
- Counterparty credit risk framework (“activities” limits)
- Resolution scheme
- Additional guidance forthcoming on systemically important financial institutions

New Capital Requirements

- Common equity minimum requirement raised gradually to 4.5% of risk weighted assets, phased in in 2013 and 2014
- Overall tier 1 capital requirement raised gradually to 6%, phased in in 2013 and 2014
- Minimum total capital requirement remains at 8%
- New capital conservation buffer of 2.5%, phased in in 2016, 2017 and 2018
- New countercyclical buffer in the range of 0% to 2.5%

New Capital Requirements (cont'd)

- Tier 1 capital:
 - common equity
 - non-common equity instruments meeting specific criteria
- Common Equity Tier 1
 - bank's common shares meeting criteria for such classification (or equivalent for non-joint stock companies)
 - stock surplus/share premium on Common Equity Tier 1 instruments
 - retained earnings and other disclosed reserves
 - common shares issued by bank's consolidated subsidiaries and held by third parties (as minority interests) that meet certain additional criteria for inclusion in Common Equity Tier 1
 - after regulatory adjustments (deductions)

Regulatory adjustments (deductions)

- Deductions from Common Equity Tier 1 include:
 - goodwill/other intangibles (except mortgage servicing rights) (net of associated deferred tax liability)
 - deferred tax assets whose realisation depends on the bank's future profitability (net of associated deferred tax liabilities)
 - treasury stock (unless already de-recognised)
 - certain specified portions of investments in financial institutions not consolidated for regulatory purposes
 - cash flow hedge reserves relating to hedging of items which are not fair valued on the balance sheet
 - any increase in equity capital resulting from securitisation transactions
 - unrealised gains and losses resulting from changes in bank's own credit risk on fair valued liabilities
 - certain other deductions

Additional/hybrid Tier 1 Capital

- To be classified as Tier 1 capital, the criteria for non common equity instruments includes:
 - subordinated to all depositors and all creditors
 - not secured or guaranteed
 - perpetual, with no incentives to redeem and no investor put option
 - fully discretionary non-cumulative dividends/coupons
 - callable by bank only after 5 years
 - any return of capital only with prior supervisory authorisation
 - capable of principal loss absorption on a going concern basis

Tier 2 Requirements

- Tier 2 capital to be simplified:
 - elimination of distinction between upper and lower tier 2 (tier 3 to be abolished)
- Minimum Tier 2 criteria:
 - original maturity of at least 5 years, with no incentive to redeem
 - callable only by the issuer and only after 5 years, with prior supervisory approval
 - dividends/coupons – may not have a credit-sensitive dividend feature
 - in a liquidation, subordinated to all non-subordinated creditors

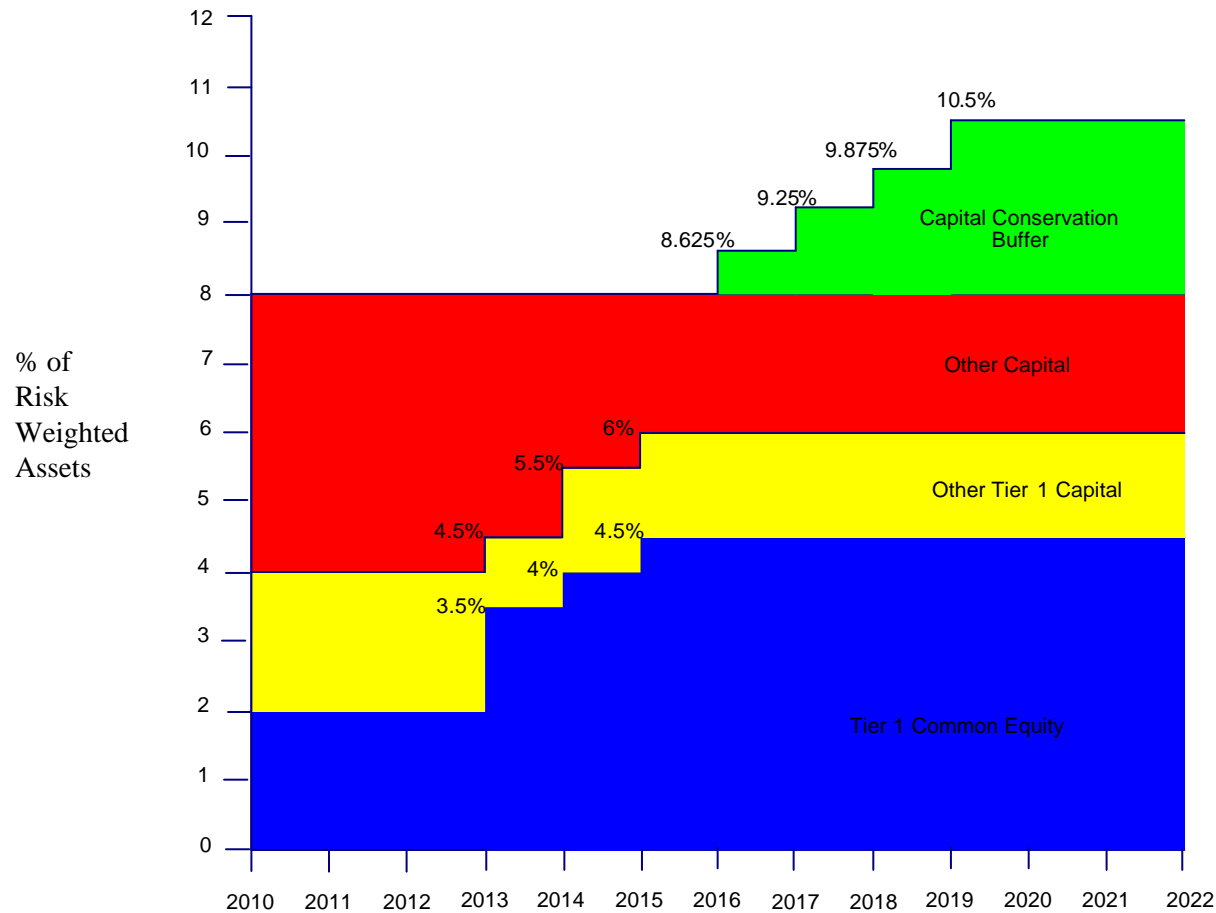
Write-off/conversion

- BCBS consultative document August 2010 – “gone concern” proposal
- Applies to all Tier 1 and Tier 2 instruments that are not common stock
- Contractual terms providing for write-off/conversion into common stock upon trigger event occurring
- Trigger event is earlier of:
 - the decision to make a public sector injection of capital without which the bank would have become non viable
 - the decision that a write-off/conversion is necessary, without which the bank would become non-viable
- Additional rules for banking groups
- “Going concern” proposals for contingent capital awaited

Phase-In of New Capital Requirements

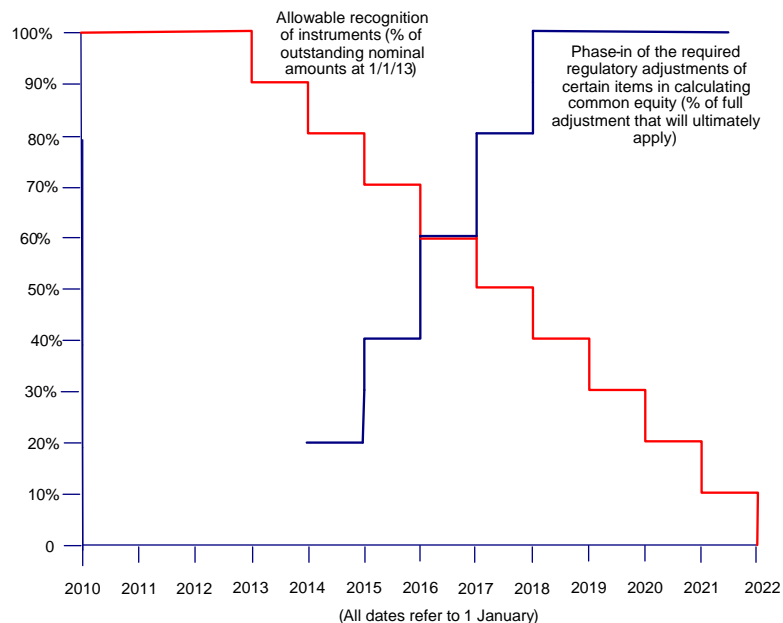
- Minimum common equity and tier 1 requirements to be phased in between 1 January 2013 and 1 January 2015:
 - common equity tier 1 minimum raised to 3.5% in 2013, 4% in 2014 and 4.5% in 2015
 - total Tier 1 capital to be raised to 4.5% in 2013, 5.5% in 2014 and 6% in 2015
- Regulatory adjustments to be phased in from 1 January 2014:
 - initially to be 20% of deduction increasing to 100% by 2018
- Grandfathering of existing instruments:
 - existing capital instruments that no longer qualify as tier 1 or tier 2 capital will be gradually derecognised from 1 January 2013 over 10 years
 - capital no longer qualifying as common equity will be excluded from 1 January 2013 with gradual de-recognition in limited circumstances

Basel III Minimum Capital Requirements



Recognition of (a) Non-common equity instruments (issued before 13 September 2010), that no longer qualify as Tier 1 or Tier 2 capital and (b) Certain non-joint stock company instruments no longer qualifying as Common Equity Tier 1 capital

Capital instruments issued after 12 September 2010 cannot benefit from the phase-out arrangements



Generally, capital instruments no longer meeting the requirements for inclusion in common equity Tier 1 capital will be excluded from common equity Tier 1 from 1 January 2013

Leverage Ratio	Supervisory Monitoring	Parallel Run	Pillar 1
		Disclosure	
Liquidity Coverage Ratio	Observation Period	Minimum Standard In Force	
Net Stable Funding Ratio	Observation Period	Minimum Standard In Force	

Capital Conservation Ratio

- To comprise common equity
- Restraints on dividends and discretionary bonuses if buffer falls below 2.5%
- Capital conservation ratio to commence in 2016 at 0.625% and increase to 1.25% in 2017, 1.875% in 2018 and 2.5% in 2019

Countercyclical Buffer

- Primary aim is to protect banking sector from periods of excess credit growth
- Aim is to temper build-up phase of economic cycle
- Each jurisdiction to be given discretion to set countercyclical buffer:
 - will be add-on to minimum buffer range under conservation buffer
 - decisions should be pre-announced by 12 months
- Special rules for internationally active banks
- Banks should calculate the buffer with at least the same frequency as their minimum capital requirements

Leverage Ratio

- Tier 1 leverage ratio to be set at 3% during parallel run period between 2013 and 2017
- Bank level disclosure of leverage ratio and components to start in January 2015
- Supervisory monitoring period to commence on 1 January 2011
- Leverage ratio not to become binding until early 2018
- Current proposals is to base leverage ratio on banks' capital (the numerator) compared to their Exposure (the denominator) on new definition of tier 1 capital.
- Exposure should follow accounting standards.

Leverage Ratio (cont'd)

- High quality liquid assets include cash and cash-like instruments in the measure of exposure
- Securitization exposures will be counted in a manner generally consistent with accounting treatment
- Derivatives exposures will either follow the applicable accounting treatment or use the current exposure method
- Other off balance sheets are included:
 - commitments
 - unconditionally cancellable commitments
 - direct credit substitutes
- 10% credit conversion factor for any commitments that are unconditionally cancellable at any time by the bank.

Liquidity Ratios

- Two proposed liquidity ratios:
 - short term liquidity cover ratio (“LCR”)
 - longer-term net stable funding ratio (“NSFR”)
- Liquidity cover ratio:
 - high quality liquid assets to cover net cash outflows over 30 day period
 - builds on traditional internal methodologies used by banks to assess exposure to contingent liability events
 - defined as stock of high quality liquid assets divided by total net cash outflows for next 30 days

Liquidity Ratios (cont'd)

- Certain high quality liquid assets (“level 1 assets”) to be included on asset side on an unlimited undiscounted basis
- Level 2 assets must comprise no more than 40% of the overall stock and must have a minimum 15% haircut
- Observation period for liquidity cover ratio commences in 2011 and ratio to be introduced at start of 2015

Liquidity Ratios (cont'd)

- Net stable funding ratio:
 - designed to promote resilience over a period of one year
 - builds on net liquid asset and cash capital methodologies used by internationally active banks
 - available stable funding (“ASF”) must be at least equal to required stable funding (“RSF”)
- NSFR should be reported at least quarterly
- NSFR will be a minimum standard by 1 January 2018

Counterparty Credit Risk (“CCR”) Framework

- Basel III makes significant changes to CCR framework with effect from 2013.
- Measures designed to strengthen risk coverage include:
 - expected positive exposure with stressed parameters to address wrong-way risk
 - requirement that banks determine capital charges for CCR using stressed inputs.
 - capital charge for mark-to-market losses associated with a deterioration in the creditworthiness of a counterparty (credit valuation adjustment)
 - higher capital charges for bilateral OTC exposures to financial institutions

Counterparty Credit Risk (“CCR”) Framework (cont’d)

- Banks to determine capital charges for CCR using stressed inputs.
- 1.25 asset value correlation multiplier to large regulated financial institutions whose total assets are at least U.S.\$100bn
- Central counterparties:
 - ongoing IOSCO work
 - standards to be finalised during 2011
 - BCBS consultative document relating to capitalisation of exposures to CCPs

Potential Issues

Potential Issues

- Traditional approaches to bank regulation focused on ensuring the soundness of individual banks
- We have moved toward a new approach that recognizes a need to focus on the soundness of the banking system as a whole and on the linkages between financial stability and the real economy
- There is also a renewed focus on evaluating the sources of vulnerability
- The Dodd-Frank and the Basel approach have some commonalities in terms of both focusing on capital, enhanced oversight, identifying activities that may pose greater risk, etc.

Potential issues

- Jurisdictional issues create challenges
- Is the focus on capital appropriate or are we too focused on capital?
- Will contingent capital instruments be a fundamental part of the solution?
- Are we creating new entities/institutions (clearing entities) that will pose systemic risks and become too-big-to-fail?
- Is Basel still too reliant on internal models and risk weighting?

Measuring the Impact of a Financial Institution's Contribution to Systemic Risk

Measuring systemic risk

- A number of different constructs have been advanced as means of thinking about systemic risk and “measuring” systemic risk
- NERA paper identifies nine components as contributing to systemic risk: interconnectedness; market concentration; implied product support; cyclicity of financial results; transparency; liquidity; capitalization; a joint analysis of liquidity and interconnectedness; and a mitigant/amplifier effect (both firm specific and sector). Once institutions are put through this “screen” then only those institutions that meet certain exposure thresholds should be put through a further test and evaluated regularly as potentially systemically important
- Other approaches focus on identifying critical elements of the financial system and identifying interconnections in order to devise a “contagion matrix”

Measuring systemic risk

- Other approaches focus on identification of early warning signs: shortages in liquidity; loss of core capital; and unexpected declines in profits
- Another study focuses on a system based on the price of insurance against distress (looks at CDS spreads and equity prices as indicators of systemic risk)
- Finally another study focuses on a financial institution's contribution to systemic risk as its propensity to be undercapitalized when the system as a whole is undercapitalized (termed its systemic expected shortfall)

The Role of the Financial Stability Board

The FSB

- April 2009, the Financial Stability Forum initiatives were assumed by the Financial Stability Board (or FSB)
- October 2009, the FSB in cooperation with the IMF and the BIS published a report on systemic risk that included definitions and the first description of a regulatory approach
- January 2010, the Joint Forum published a report addressing a number of key recommendations for financial market regulation
- October 2010, the FSB publishes “Reducing the moral hazard posed by systemically important financial institutions”
- November 2010, the G20 endorsed the FSB’s policy framework contained in its October 2010 paper
- February 2011, the FSB publishes “Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability”

G-20 – Systemically Important Financial Institutions

- G-20 meeting in Seoul endorsed FSB’s proposals to reduce “moral hazard risks” posed by SIFIs and address the “too big to fail” issue
- SIFIs should have loss absorbency capital commensurate with system-wide losses that would be occasioned by their failure
- Initial focus on global SIFIs (GSIFIs):
 - FSB and national authorities to draw up list of GSIFIs by mid 2011
- GSIFIs to be required to have greater capacity to absorb losses than under proposed Basel III minimum standards
- More intensive and effective supervisory oversight
- BCBS to produce report on additional loss absorption capacity of GSIFIs by mid 2011

G-20 – Systemically Important Financial Institutions

- Resolution Frameworks:
 - all jurisdictions should have a resolution framework in place to facilitate rapid resolution of a failing institution
 - depositors should be able to continue to access their deposits
 - authorities must have power to transfer and sell viable parts of the entity
- Internationally active institutions:
 - sharing and co-operation agreements
 - elimination of laws protecting domestic creditors at expense of foreign creditors
 - for GSIFs, co-operation agreement between home and host authorities
- FSB to draw up criteria for assessing resolvability of SIFs by March 2011

UK Financial Sector Stability Developments

- Special Resolution Regime – created powers for UK authorities to transfer all or part of a failing bank’s business to a private sector purchaser or to a publicly-controlled “bridge” bank or to take the bank into temporary public ownership
- Bank insolvency regime and bank administration regime
- Bank recovery and resolution plans (“living wills”)
- Investment banks – special administration regime

Managing Risk Institution by Institution

Managing Risk Institution by Institution

- Discussion of Dodd-Frank requirements
- Discussion of Basel III requirements