The Systemic Risk Council

TO THE FINANCE MINISTERS, GOVERNORS, CHIEF FINANCIAL REGULATORS, AND LEGISLATIVE COMMITTEE LEADERS OF THE G20 COUNTRIES

This year will mark the tenth anniversary of the beginning, in early summer 2007, of what became the Great Financial Crisis. At a moment when efforts to complete vital, robust banking reforms in Basel seem to have stalled, when speculation swirls about the possibility of the U.S. repealing parts of the Dodd-Frank Act and when, in prospect, EU and UK financial policy could conceivably diverge for the first time since the collapse of the post-WWII Bretton Woods international monetary order, we, the members of the Systemic Risk Council, have decided to put on the record our view of the essential ingredients of a safe and sound financial system that can serve the interests of people, businesses, and entrepreneurs in individual nations and across the world. We stand ready to make more specific comments and recommendations as details emerge of the reviews underway at the global level and in the U.S. and Europe.

Pillars of the Shared Reform Program

Eight years have passed since efforts began, only a few months after the systemic collapse of late 2008, to make the financial system more resilient. In each key jurisdiction the reforms have combined distinct national initiatives under the umbrella of a shared international program. Agreement—voluntarily entered into and pursued by sovereign jurisdictions—on the shared elements has reflected acceptance that, in certain areas, international minimum standards and policies are in the common interest given the interconnectedness of cross-border banking, capital markets, and insurance. The five pillars of the shared part of the reform program have been:

1. mandating much higher common tangible equity in banking

groups to reduce the probability of failure, with individual firms required to carry more equity capital, the greater the social and economic consequences of their failure;

- 2. requiring banking-type intermediaries to reduce materially their exposure to liquidity risk;
- 3. empowering regulators to adopt a system-wide view through which they can ensure the resilience of all intermediaries and market activities, whatever their formal type, that are materially relevant to the resilience of the system as a whole;
- 4. simplifying the network of exposures among intermediaries by mandating that, wherever possible, derivatives transactions be centrally cleared by central counterparties that are required to be extraordinarily resilient; and
- 5. establishing enhanced regimes for resolving financial intermediaries of any kind, size, or nationality so that, even in the midst of a crisis, essential services can be maintained to households and businesses without taxpayer solvency support—a system of bailing-in bondholders rather than of fiscal bailouts.

Those regulatory reforms have been accompanied by some major developments in the practice of prudential supervision, notably regular stress testing of key intermediaries and service-providers. As well as being directed to the central issue of whether firms can survive in severe adverse scenarios, stress testing has brought much greater transparency to prudential judgments and, therefore, is helping to improve the quality of public debate on financial stability policy.

Although policymakers in many jurisdictions, elected and unelected, identify themselves and their particular country as leaders on one or more of these fronts, the truth is that these core reform measures are global. That is because they are a precondition for maintaining access to foreign markets and, reciprocally, for admitting foreign intermediaries into home markets.

In the considered view of the Systemic Risk Council ("SRC"), these five pillars remain as vital as ever. The U.S. and EU, as well as the other members of the G20, have a shared interest in maintaining a system of *minimum international standards* for intermediaries that are

internationally active or whose domestic activities have a material impact on other countries and for markets that bring intermediaries from different jurisdictions together.

Now is Not the Moment to Relax or to Retreat

The costs of the financial collapse remain a daily reality for millions of people around the world. Although monetary and fiscal policymakers acted to avoid a repeat of the Great Depression of the 1930s which blighted lives and communities for decades, and while political leaders similarly avoided revisiting the perilous mistakes of 1930s-style protectionism, the painful fact is that economic recovery has been unusually slow and highly uneven. What is more, building a resilient financial system is unfinished business almost everywhere. Among other things, we would highlight the following:

- the work to put in place effective resolution regimes and plans for clearinghouses is incomplete but, given their mandated role at the center of capital markets, is absolutely vital;
- the credibility of the resolution plans for large and complex banks and dealers also needs to be put beyond doubt;
- the regime for those "shadow banking" activities and intermediaries that represent a risk to stability remains underdeveloped;
- the accounting and prudential rules requiring banks and others to recognize expected losses promptly, thereby avoiding the hazards of forbearance, are still uneven across jurisdictions; and
- the role of government-guaranteed agencies and intermediaries in creating risks to stability via distortions in credit markets has yet to be addressed by the reform agenda.

Far from emphasizing the importance of completing that work, there are calls to undo parts of the reform program. Legislators and regulators should beware of the hazards of relaxing, suspending, or back-tracking now. Two features of the current macroeconomic environment would make dilution of the five core pillars especially inauspicious. First, the levels of debt in the world economy have continued to increase in the years following a crisis itself triggered by excessive debt.

Separately, when the next recession comes, central banks and fiscal authorities will not have nearly as much firepower as they were able to deploy in 2009 and maintain until now. Most commentators believe that central bank policy rates will not normalize for some years and that, even when they do, they are likely to stabilize well below the past norm. Combined with central banks already having bought huge proportions of governmental debt and other bonds, the scope for monetary stimulus is, therefore, likely to be much narrower than any advanced economy is used to. On the fiscal side, given a cumulative debt overhang, few governments will have the capacity to provide meaningful stimulus in substitution for monetary policy without exacerbating longer-term debt dynamics.

That being so, when the next downturn comes, financial institutions will likely be more exposed to losses than in the past. The reason is simple. For any initial shock that kicks off a slowdown, the macroeconomic policy response will probably be weaker (for the reasons noted above). In consequence, more businesses are liable to fail and more jobs are liable to be lost. As defaults mount and financial intermediaries come under pressure, any defensive measures by lenders to repair their balance sheets would constrain the supply of credit and other services, which would amplify the slowdown, and so on through feedback channels that are now widely recognized (if still imperfectly understood). These mechanisms will be potent—sacrificing jobs and welfare—even if crisis is averted.

To be clear, this is not a prediction of doom. The SRC no more knows the source and severity of the shock that brings about the next slowdown than anyone else. And banking institutions now carry more equity for absorbing losses. Nevertheless, a financial system in an economy with impaired macroeconomic stabilizers is more exposed to risk than otherwise. This is particularly so when, as a proportion to global GDP, the amount of debt outstanding globally has continued to increase, reaching levels significantly higher than before the crisis. It will be individuals and their families—distant from the financial sector and its regulators—who bear the costs of those risks crystallizing. If the initial shock were large enough to set off another banking crisis, a number of G-20 countries could face dire consequences.

Far from being a moment to relax any of the five pillars of reform, therefore, it may be prudent to adopt tougher policies while the macroeconomic arsenal is replenished and as debt levels are reduced. Simply put, the financial system reform program was not calibrated for our present predicament—namely a world in which productivity growth has proven elusive, the debt overhang has increased, and macroeconomic-stimulus capacity is stretched. In these circumstances, we believe that regulatory policymakers should consider whether to require banks (and possibly some others) to carry more equity than prescribed for the steady state in the years immediately following 2008-09. The SRC has therefore been concerned about reports that the Basel Committee on Banking Supervision, and even the Governors and Heads of Supervision ("GHOS") who oversee the prudential standard setters, have been debating softening their plans for the final capital standards in the face of intense industry pressure.

That would be a perilous course. When bad times come, as sooner or later they surely will again, strong banks lend, weak banks do not. That much has been apparent in recent years: the jurisdictions that took the earliest, most determined actions to build financial system resilience have benefited from more solid macroeconomic recovery than those of their peers adopting a more gradual or less committed regulatory-reform strategy.

We accordingly urge the Basel Committee and the GHOS to steer a steady, robust course in setting floors for the risk weights derived from banks' own internal models. The central policy rationale for prudential regulation in the first place is that bankers cannot possibly be expected to internalize the social costs of their institution's failure or of their rationing the supply of credit and other services in order to avert outright failure. The "externalities" can be particularly potent in property-related lending, but are not limited to that. Unconstrained reliance on internal models, which was a tragic flaw in Basel II, should not be subtly incorporated into Basel III.

Trade-offs within the Common International Reform Program

None of this is to say that the original financial stability reform program was right in every respect. It would be a strange world if nothing could be learnt from the past few years. A review of the details, nationally and internationally, could make sense. Such a review might reasonably include looking at whether the full force of the reforms should apply to any groups of small domestic intermediaries that, even when *taken together*, are neither locally nor internationally significant.

Nor is it to insist that every element of each country's domestic reform legislation is absolutely central to the resilience of the financial system. A number of important reforms were directed to protecting consumers and investors from misselling and other abuses, rather than explicitly at stability. But no one should doubt that the financial system itself would need to be more resilient than otherwise if households and small firms were again exposed to the risk of being persuaded or induced to take on more debt than they can prudently bear.

Thus, while the SRC is focused on the stability of the system as a whole, we urge new governments and legislators not to put impediments in the way of finishing the job of building a resilient financial system that can serve households and businesses through thick and thin. While not *sufficient* for economic dynamism and prosperity, confidence in a stable financial system is an *absolutely necessary* precondition for dynamism and prosperity to be sustained.

Most vitally, governments and legislators should resist the siren calls of those who would have them reduce equity standards for big and complex firms, economize on liquidity requirements, retreat on central counterparties, or dismantle the new resolution regimes. Were they, against our expectation, to give way, they would put the welfare of their citizens in jeopardy. They would in effect be opening the door to additional and uniformly unpopular, taxpayer-funded bailouts. They would also be exposing economically marginalized industries and regions to even greater risks than those they already face given changes in the real economy.

Further, it must be recognized that the package stands as a package. If one or more of the five pillars were diluted or dropped, others would need to be strengthened. To give only one example, if resolution regimes were dismantled, the system's resilience—meaning the confidence that essential services could be maintained through a crisis—would be materially reduced, leaving governments in the position of being, again and contrary to every intention, a fiscal backstop to the financial system. Quite apart from the political costs of retreating to the old, failed arrangements, the public finances of few countries are equipped to take the strain, which could result in higher debt-servicing costs than otherwise (entailing higher taxes, lower public programs, or both). In that case, we believe that dismantling resolution regimes would need to be met with materially higher equity requirements.

Trade-offs with Local, National Reforms

A number of countries have adopted specific reforms that plug gaps in their own regime and so help to bring them into line with pre-crisis international norms (perhaps the most notable example being the U.S. moving to require derivatives-market participants to carry some equity).

Separately, many countries have also exercised their sovereign right to adopt reforms that go beyond or complement the shared international program. For example, and perhaps most notably, the U.S. adopted rules that bar banking institutions from running proprietary-trading desks and sponsoring or investing in hedge funds and private equity; and the UK now requires significant domestic retail banks to be ringfenced from any wider group in which they are housed.

Those various supplements to the shared international package affect the resilience of the financial system in key financial centers. Were they to be diluted, elements of the shared reform program would need to be strengthened or other structural reforms introduced if the system's resilience were not to be impaired. Further, such is the international significance of the financial centers of the U.S. and UK that other jurisdictions would have a legitimate interest if their systems' resilience were to fall below reasonable expectations.

Gaps: Regulatory Arbitrage

The SRC does not wish to be understood as saying or implying that everything in the global reform program is as it should be. In particular, we remain concerned, as flagged in our past comment letters to the Financial Stability Board, that not enough has been done to establish a response to stability-threatening manifestations of what has become known as "shadow banking."¹ We urge the governments and legislators of the G20 countries to take a renewed interest in this area, giving domestic and international regulators a clearer sense of direction.

Policymakers should not doubt that with the formal banking sector required to be more resilient, there will be powerful forces pushing activity out of *de jure* banks into other types of firm, vehicle, or structure. Much of that could be for the good, adding to the vibrancy and depth of capital markets. But, to put it gently, it would be imprudent to disregard the likelihood that some banking activity will migrate to intermediaries or structures that replicate banking-like fragility through leverage and liquidity mismatches. If that happens, the executive and legislative branches will, later or sooner, face a choice between allowing socially costly distress or bailing out such nonbanks.

content/uploads/2016/10/Systemic-Risk-Council-Letter-to-FSB-re-Asset-Management-Proposals.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Jan. 13, 2016), *available* at http://www.systemicriskcouncil.org/wp-content/uploads/2016/01/SRC-Letter-to-SEC-re-Open-End-Fund-Liquidity-Risk-Mgmt-01-13-16.pdf; Letter from Sheila Bair, Chair, Systemic Risk Council to the Financial Stability Board (Jan. 18, 2013), *available at* <u>http://www.systemicriskcouncil.org/wp-content/uploads/2013/01/Systemic-Risk-Council-Letter-on-Money-Market-Funds-1-18-13.pdf</u>.

¹ See Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Oct. 15, 2016), available at <u>http://www.systemicriskcouncil.org/wp-</u>

The SRC wishes to repeat that relying on monitoring developments, which for the moment seems to be the default approach, is a recipe for failure given the obstacles to flexible, timely regulatory initiatives. That, more or less, was exactly the mistake of the early-2000s, as many people, including some SRC members, could testify based on first-hand experiences. A clear substantive policy on shadow banking—focusing on liquidity mismatches and leverage, and so distinguishing between different asset-management activities and structures—is a glaring gap in the regimes of every major jurisdiction. We therefore urge legislators and governments in the G20 countries to address this issue squarely through whatever means appropriate—whether by legislation, executive action, or other policies.

Cross-Sectoral Stability Policy: The Importance of Institutions that Take a System-Wide View

It was also at the beginning of the last decade that policymakers (elected and unelected) gradually became aware of the need for a system-wide view of stability policy. In the aftermath of the Great Financial Crisis, key jurisdictions finally established formal domestic financial stability bodies to that end. The crucial change was that these new bodies were not intended only to be fora for exchanging views, but were vested with significant powers to enable them to act to mitigate serious threats to stability.

These basic changes should persist. In anything like today's world, no jurisdiction is going to be able to maintain domestic financial stability without institutions that have delegated powers to act to ensure the resilience of any kind of intermediary that, in combination with others and taking account of the broader macro-financial structure, represents a material threat to stability. This, to be clear, is much less about the *probability* of an intermediary actively experiencing distress, than it is about the wider *impact* of distress when it occurs. Making those judgments requires a *system-wide view*, covering the economy, intermediaries, markets, and the financial system's infrastructure.

It is not for the SRC to prescribe the detailed regulatory architecture for

particular countries, since that must reflect local constitutional provisions, traditions, and norms. There are understandable variations across jurisdictions. We do, however, stress this fundamental point: each G20 country needs a financial stability body that can ensure that system-wide regulatory policies are determined and implemented promptly in a joined-up way in the face of evolving threats.

Summing Up

The resilience of national financial systems is a vital good, essential for citizens to live decent lives. It is necessary for individuals, families, businesses, and entrepreneurs to be able to plan for the future, transact with each other, and commit their savings to new ventures. Such, however, is the interconnectedness of today's world that no country can make its own system resilient without cooperation from its peers. In a nutshell, the resilience of the international financial system is a common global good, for which the G20 authorities are, in effect, joint trustees. By so doing, they act in their national interests.

Like any other type of business, banks, dealers, and other kinds of financial intermediary need to be able to fail as well as to thrive. The resolution-regime pillar of the reform program amounts to making banks, dealers, and other financial intermediaries a proper part of a market economy: in order to find a place in a system of free enterprise, they must be able to fail in an orderly way when they are not good enough to thrive and survive.

Even orderly failure can be socially costly, so the other pillars of the regulatory reform program have aimed to ensure that the probability of distress is much lower than a decade ago. That has meant higher equity for all regulated financial institutions and much higher equity for the largest and most complex intermediaries. It has meant higher liquidity in banks and, although not yet mandated, it ought to constrain liquidity risk in shadow banking. Finally, it has entailed acting to produce much less complex networks of counterparty credit exposures among intermediaries in derivatives and other highly interconnected markets, supported by clearinghouses that could be resolved without

fiscal solvency support.

Those propositions remain as true today as they did in 2009. We appeal to elected governments and legislators, new and old, not to dilute the five pillars of the reform program for system stability.

As unelected policymakers know, central banks and fiscal authorities are very unlikely to be able to bring the same firepower to dampen the impact of the next recessionary shock, wherever it comes from. We appeal to regulatory authorities not to dilute their work, and in some cases to err on the side of caution in requiring equity levels that will prove prudent when the next downturn arrives given the persistent overhang of debt.

Ten years on from the beginnings of the crisis, now is not the moment to bow to financial industry lobbyists or to short-term temptations. The SRC urges policymakers to be discriminating as they review the work of the past decade, leaving stability as a priority.

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