STATEMENT BY THE SYSTEMIC RISK COUNCIL ADDRESSED TO THE FINANCE MINISTERS AND CENTRAL BANK GOVERNORS OF THE G20, THE FINANCIAL STABILITY BOARD, AND INTERNATIONAL STANDARD-SETTERS

October 9, 2020

REIGNITING REFORMS TO ENSURE A RESILIENT AND STABLE FINANCIAL SYSTEM: A SECOND PHASE?

A decade ago the G20 leaders, supported by their finance ministers and central bank governors, approved a program of reform to restore the resilience and stability of the international financial system in the wake of the 2007-09 crisis. It is timely to think about what was left out or undone in the light of events since the spring, when the COVID pandemic upended financial markets.

Ahead of a public webinar on Wednesday, October 14, 2020,[1] the Systemic Risk Council summarises here what we believe are key issues and problems that must be covered by this debate. We believe that more reforms are needed, and that the opportunity exists to pursue them.

<u>Background: the core features of the 2009/10 program, and the strains of spring 2020</u>

As the Systemic Risk Council (SRC) set out a few years ago, the shared international reform program had five core pillars:[2]

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[1] *See* CFA Institute Webinar, Ensuring Financial Stability: Relaunching the Reform Debate after Pandemic Dislocation, available at https://global.cfainstituteevents.org/event/43d689a4-d3dc-4464-a6fa-586ed6c697b3/summary?environment=P2&5S%2CM3%2C43d689a4-d3dc-4464-a6fa-586ed6c697b3=.

[2] *See* The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wpcontent/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf.

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.

While a good deal has been achieved, progress in planting and buttressing those five pillars has been somewhat uneven, with considerably more done on the first and second (banking) than the others. Across the piece, however, some areas became sidelined, and since the initial surge of activity there has been a degree of backtracking in some major jurisdictions (for example, on banks' leverage, and resolution planning for regional banking groups, in the US; on sticking to resolution policies, and excessive forbearance, in some EU member states).

In the spring of this year, the system faced its first significant test. The results were mixed. No major bank or dealer collapsed. But as SRC observed in its letter to ministers and governors in mid-March:[3]

> "Covid-19 strikes the world at a time when too many corporations around the world are over-indebted, and after a period during which persistently favorable market conditions caused traders to take aggressive positions, exposing them and the system to spikes in volatility, let alone a collapse in asset values. Opportunities to restrain market leverage by raising margin or haircut requirements in capital markets were missed."

[3] *See* Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Finance Ministers and Central Bank Governors of the G20 Countries (Mar. 19, 2020), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/03/SRC-signed.pdf.

The upshot was a brief but severe dislocation in core capital markets, including the US Treasury bond market, bringing forth a support operation from the major central banks that dwarfed anything seen during the early months of 2009. While views vary on the proportionality of the central banks' intervention, the implications are that leverage and/or liquidity mismatches in markets were excessive, and that market participants of all kinds have again benefitted from a state safety net. Those are not conditions under which resources are likely to be allocated efficiently, or where systemic resilience is adequately assured. That starting point is fortified by chatter, unsubstantiated so far as we know, of funds of various kinds finding themselves under pressure.

In what follows, we identify areas where reform should be seriously contemplated under two headings: banking and resolution; and levered markets and shadow banking.[4] No attempt is made here to prioritize among the issues.

<u>Banking, and Resolution</u>

Banking is the area where most has been done since the 2007-09 crisis. Nevertheless, apart from whether some of the more recent relaxations have gone too far and so should be unwound, there is a series of other issues:

1) *Avoid further reductions in equity requirements, and review whether the steps to unwind the earlier reforms have all been wise*

   Given the build-up of leverage in the non-financial sector, greater strain in public finances and great uncertainty about the medium-term macroeconomic outlook, a resilient financial system is more important than ever.

   Steps to unwind the post-2007-09 crisis reforms should cease, and some of the relaxations already introduced should be revisited once economic conditions stabilize.[5] (The SRC notes that some commentators thought

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[4] This letter does not cover a wider set of issues around vulnerabilities to international macroeconomic imbalances and volatile capital flows.

[5] *See, e.g.,* Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (July 31, 2020), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/07/Comment-Letter-of-Systemic-Risk-Council-on-FSB-Consultation-on-CCP-Resolution-Guidance7.31.2020.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, and Jelena McWilliams, Chair, Federal Deposit Insurance Corporation (July 16, 2019), available at https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-

the original reform package for bank capital adequacy did not go far enough.)

2) *Banks' liquidity buffers need to be usable*

The big issue here is whether prescribed liquid holdings are useable when needed, given that regulation binds in good times but market sentiment does so in bad times.

One possible alternative would be to move toward a system where banks' short-term liabilities had to be covered by assets that can be discounted at the central banks.

Another would be to introduce a system of temporary regulatory waivers so that liquid assets can be used, although it is unclear whether that would help banks facing market pressure.

3) *It is not clear how policy on where liquidity must be held fits with cross-border coordination of resolution plans*

Over recent years, prudential supervisors have developed policies for which legal entities in banking groups should hold minimum levels of liquid assets. Since this is perceived by some as introducing degrees of jurisdictional ring-fencing, it is not clear how it fits with plans for resolution of groups, especially so-called single-point-of-entry (SPE) resolution plans.[6]

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content/uploads/2019/07/SRC-Comment-Letter-on-Resolution-Planning-Requirements-for-US-Regional-Banks.1.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Mar. 18, 2019), available at https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wpcontent/uploads/2019/03/New-CCP_Resolution_-_SRC_-_March18__2019.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System, and Joseph Otting, Comptroller of the Currency (Aug. 8, 2018), available at https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wpcontent/uploads/2018/08/SRC-Comment-Letter-on-eSLR-and-Volcker-Rule-Aug-8-2018.pdf.

[6] Under SPE resolution, losses exceeding equity, together with any recapitalization need, are passed up from operating subsidiaries to one legal entity (canonically, a non-trading holding company), and only that entity goes through a formal resolution process (if necessary). Under multiple-point-of-entry (MPE) resolutions, a group is structured so as to create distinct subgroups, insulated from each other, which can each be put through a subgroup-level SPE resolution (if necessary). Most groups designated by the international authorities

It would helpful for the Basel community to explain the coherence of these policies, if necessary confronting any official-sector doubts about the credibility of resolution plans. (The Financial Stability Board's (FSB's) Key Attributes for resolution, and in particular the plans for SPE resolution, were designed to flush out cross-border differences ahead of crises, rather than leaving them to be discovered in real time during a crisis.[7])

4) *Not enough has been done to make resolution, instead of bailout, a credible tool for the failure of individual banks*

   The central lesson of the solution to the inflationary problems of the 1970s and 1980s is that good policies are credible only if departing from them is painful for those responsible. So far, we have not observed efforts by the leading supervisors and resolution authorities to tie themselves publicly to the mast of the resolution regimes and plans they have developed. Action of some kind is needed on this front if the regimes are to be other than a paper constitution for banking.[8]

   Options include placing supervisors under a duty to put a firm into resolution once it reaches the point of non-viability; barring the central bank from lending to such firms until restored to viability by resolution; or the authorities publishing their benchmark (expected) sequence of resolution responses, so that they can be held accountable (entailing having to give a public explanation, at an appropriate time) if and when they depart from that benchmark order of actions for some reason.[9] There are doubtless other possibilities, but the broader point is that the

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as globally systemically significant have SPE resolution plans, but some have prepared or are preparing for MPE resolution. The categorisation of groups into SPE or MPE is very important, and needs to be widely understood in financial markets.

[7] *See* The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wpcontent/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf.

[8] Insufficient emphasis was given to credibility and so to self-binding in the FSB's recent consultative document on the reforms to cure the Too Big to Fail problem. *See* Financial Stability Board, Evaluation of the Effects of Too-Big-to-Fail reforms: Consultation Report (June 28, 2020), available at https://www.fsb.org/wp-content/uploads/P280620-1.pdf.

[9] This could entail the authorities publishing the sequence of resolution steps for each significant bank or dealer group.

authorities need to put their credibility and standing behind the technical reforms they have introduced.

It is therefore important that, through speeches, interviews and testimony, top officials in central banks, prudential supervisors and resolution authorities put themselves (their office) on the line in the way that an earlier generation of monetary officials did in achieving price stability.

This is important to generate the market discipline, among investors and banks' management teams, that a credible alternative to bailout or chaotic bankruptcy can bring.

5) *It is not yet clear how the authorities would plan to resolve multiple banks in a simultaneous systemic collapse*

For some years, various commentators have expressed scepticism about the credibility of the post-2008 resolution regimes on the grounds that they could not cope, it is argued, with the simultaneous collapse of multiple systemic institutions. While SRC members think this argument is overdone --- because idiosyncratic failures do occur, and a successful bailin of just one significant group would change incentives among bank investors and mangers --- the authorities do need to plan for circumstances where they find themselves needing to stabilize a number of fundamentally broken systemic firms more or less simultaneously.

One possible approach would be for the authorities to be granted a power, subject to political oversight or authorization, to resolve multiple firms without having to demonstrate in real time that each and every firm met the conditions for resolution taken alone.

Unless something like that is available, jurisdictions will need to do more planning for how taxpayer bailouts could be executed in ways that gave the failed firms strong incentives to exit the support operation in a timely and efficient manner, while minimizing losses to the public purse. The 2008 bailouts vary a lot on those criteria of effectiveness.

6) *The Basel capital regime is too complicated*

The Basel regime for capital adequacy has requirements for total capital, Core Tier 1, Tier 1, Tier 2, and so on. This is a hangover from the Basel 2 regime, and is more complicated than it needs to be in a world with resolution regimes. It would be simpler if there were minimum requirements only for going-concern loss-absorbency (basically, tangible common equity for joint-stock firms) and gone-concern loss-absorbency (bailinable bonds, perhaps some other subordinated bonds, and so on). A simplification of that kind would make it much easier for the authorities and banks' boards to explain their resolution plans.

We would expect this kind of idea to be resisted by those who make a living out of the complexity of the current regime, whether as advisors and issuing houses, analysts, or asset managers.

Separately, the roles of host and home supervisors need to be adapted to the roles of different jurisdictions in the resolution of a distressed international banking group. Roles are likely to differ according to whether a group has been designated suitable for single-point-of-entry or multiple-point-of-entry resolution strategies. Alignment of supervisory and resolution roles would probably also help to simplify the regulatory and supervisory regime.

7) *The integrity of stress testing needs to be underpinned*

Stress testing, an innovation deployed with great effectiveness by the US in the spring of 2009, has become central to banking supervision. The SRC applauds this. But the technical complexity of stress testing leaves a question mark around how the integrity of the process can be assured. The challenge is how to ensure integrity without, in slow motion, undermining the policy's effectiveness in preserving resilience.

One response, advocated by parts of the industry, is to embrace much greater transparency around the underlying models and process, and to implement stress testing as if it were a mechanical rule. The Fed has moved in this direction, which the SRC thinks was probably useful to the banks. But it risks turning stress testing into a box-ticking exercise, undermining the capacity of supervisors to respond to previously unanticipated vulnerabilities. This is especially so given the important role that stress testing can play during a drawn-out crisis, when new extreme tail events become plausible. Judgment here cannot be ducked, and it is important to avoid a false choice between, on the one hand, judgment with unconstrained discretion and, on the other hand, a rigid rules-based approach that is gamed by the banks.

Another possible route to underpinning the integrity of national stress-testing processes would to let independent outside observers view the process, including model adjustments, from end to end.

An international standard or guidance for do’s and don’ts in stress testing, drawing on a wide range of experience in different jurisdictions, could be useful.

8) *Dynamic macro-prudential policies have been employed very unevenly across jurisdictions*

The major jurisdictions have varied enormously in their use of the counter-cyclical capital buffer. The US has not used it at all. The UK deployed it permanently, but with an offsetting reduction in other capital requirements, so that, big picture, the effect is to equip the authorities to conduct counter-cyclical *easing* of prudential policy rather than to operate a symmetrical dynamic policy. In the Euro Area, some member states have used the dynamic buffer, others have not, and the currency union’s central authority (the European Central Bank) is not empowered to operate a system-wide dynamic policy.

If dynamic policy is not going to be used during strong upswings in credit and asset markets, one option would be to further increase static equity-ratio requirements. But it is not obvious that they are perfect substitutes.

Another option would be to use stress-testing for setting dynamic, across-the-board capital policy rather than (or alongside) using it as an input into setting capital requirement bank by bank.

In that connection, the authorities need to do more to incorporate curbs on distributions (dividends, equity buy-backs, and bonuses for high-end management) into their approach to dynamic prudential policy (micro, and macro). At the beginning of the COVID crisis, it would have helped to have clearer policies, and arrangements for cross-border coordination, in this area.

<u>Levered markets, and shadow banking</u>

In comparison with banking, much less has been done on systemic vulnerabilities in non-banking intermediation. Arguably that was on display during this spring’s market dislocations, with central banks’ actions effectively delivering liquidity insurance and assistance well beyond the banking system. It is hard to claim, as some commentators have, that Exchange-Traded Funds and other structures weathered the crisis successfully, when the whole market was propped up by central bank support operations. At most, agnosticism tempered with concern about market fragilities is warranted. At worst, serious vulnerabilities were obscured by the monetary and credit-market interventions.

SRC wishes to air the following issues:

1) *There is a need to reinvigorate work on finding a broadly shared international approach to containing systemic risks from shadow banking*

   By "shadow banking," we mean forms of intermediation that replicate in some way one or more of the fragilities in banking: exposure to liquidity runs, high leverage, opaque and therefore hard-to-value asset portfolios. As was recognized a decade ago, an inevitable effect of reregulating banking was to increase incentives to conduct business substantively similar to banking in entities that are not banks as a matter of a jurisdiction's law. It would be a mistake if nothing was done to check excessive vulnerabilities of this kind until after one or more shadow banks is bailed out by the taxpayer.

   Recent stresses among open-ended credit funds and exchanged-traded funds, somewhat masked by the central banks' actions to prop up market prices, warrants careful examination as part of this exercise.

   Given the international mobility of capital, it is not easy for any jurisdiction to tackle these vulnerabilities unless others do so, and in a broadly similar fashion. Just as that problem was the impetus for the Basel accords for banking in the 1980s, so national authorities need to cooperate in this area, most obviously via the FSB. The G20 could usefully give the FSB a push to reinvigorate its work on these issues.

2) *Dynamic macro-prudential policy toward market leverage*

   Broadly related to that, the authorities have not found or utilized ways to check the accumulation of excessive leverage in traded markets.

   Both haircuts on collateral requirements in secured financing markets (such as sale and repurchase, or repo, contracts) and initial margin requirements on centrally cleared derivatives transactions constrain leverage at a transaction-by-transaction level. Yet even though easy monetary policy has had the side effect, again, of fueling a search for yield, the authorities did not ensure that collateral requirements leant against the risk of excess.

One option is counter-cyclical requirements. Another would be higher static requirements. What should be avoided is acquiescing in pro-cyclical policies in firms and clearing houses, which have the effect of fueling the rise in leverage until, fairly suddenly, the retreat is sounded and enforced.

3) *Resolution of clearing houses is urgent unfinished business*

As SRC has commented before, there seems to be a stalemate among domestic authorities, and in international bodies and standard-setters, about how to handle a distressed central-counterparty clearing house without amplifying the underlying crisis. This is dangerous. It is not safe to assume recovery plans will always work well, especially if they induce pro-cyclical behavior by firms by haircutting their claims.[10]

This matters, politically as well as economically, because the policy of forcing more activity through clearing houses does not make sense unless clearing houses are safe. Many are super-systemic, and so every eventuality must be catered for in their design, operation, and regulation.

4) *Market regulators should have a statutory responsibility for system-wide stability*

In some jurisdictions more than others, regulatory authorities responsible for capital markets --- securities markets, and derivative markets --- seem to continue to place less of a priority on financial stability than on their historical core mission of investor protection and efficiency.

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[10] In its letter to the Financial Stability Board of July 31, 2020, SRC commented that the current draft international guidance is not fit for purpose. *See* Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (July 31, 2020), available at http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2020/07/Comment-Letter-of-Systemic-Risk-Council-on-FSB-Consultation-on-CCP-Resolution-Guidance7.31.2020.pdf.

This could be remedied by legislatures giving such agencies a statutory responsibility for stability (where they do not already have one). Another approach is to empower another agency, with lead responsibility for stability, to have an override power in respect of the market regulators, but where that exists (e.g., the US for some matters) it seems to be culturally difficult for such powers to be exercised.

The approach aired here would give market regulators greater incentives, and responsibilities, for conducting rigorous stress testing of non-bank intermediaries, vehicles and structures whose distress could spill over into the markets with material social costs.

<u>Summing up: addressing unfinished business on financial system resilience and reform</u>

The reforms that followed the 2007-09 crisis have plainly made some parts of the financial system more resilient. But a combination of the vulnerabilities exposed in the spring, backsliding on some reforms, and lack of progress with others mean it is timely to revisit whether enough has been done to protect the real economy --- families and businesses --- from financial system fragilities. SRC believes that the debate is needed, and some new reforms are likely to be warranted. Although no intermediary failed in the spring, the enormous scale and rapidity of central banks' support operations simultaneously signaled the existence of worrying vulnerabilities even while they masked precisely where the system was weakest.

The purpose of this letter is not to make concrete proposals but to help promote that debate, which we hope will be helped by the webinar on Wednesday October 14th.

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