

Resolving crises in global financial institutions: the functional approach revisited

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Disclaimer

In a nutshell

- Institutions have become too large, too complex and too global to wind down.
- They perform functions that are critical for financial systems and the real economy.
- We need effective means to safeguard functions so institutions can be allowed to fail.

The paper revisits a proposal presented at a Federal Reserve Bank of Chicago conference in October 2004 in the light of the experience of the current crisis.

Lessons from the crisis

- Need for a way to wind-down systemically significant financial institutions – whatever their form, sector or regulatory status.
 - Without such tools, they will be bailed out at massive cost to the public purse and with huge moral hazard distortions
- Need for a new regulatory architecture
 - Achieve consistency between regulation and resolution by adopting a functional approach

The wind-down of a large cross-border institution is complex

- Complex corporate structures: “form does not follow function”
- Asymmetries of exposures across jurisdictions
- Multiple (conflicting) proceedings and competencies
- Diversity of national crisis resolution arrangements
 - Intervention thresholds
 - Intervention tools
 - Priorities and client asset protections
- Asset grab
- Practical constraints (need for speed, time zones)

....and the current legal regime inadequate.

- Existing resolution arrangements
 - do not provide for continuity of functions
 - do not work in a cross-border context
 - do not apply to all types of financial institutions
 - do not provide for resolution of group structures
 - are focused on the preservation of domestic interests and impede effective cross-border solutions.

What is to be done?

“Protect functions, not institutions”

- Step 1: Identify critical functions
- Step 2: Take actions in national jurisdictions to protect critical functions
- Step 3: Ensure that national approaches for preserving critical functions are consistent across borders

Step 1: Identify critical functions

- A critical function is one that needs to be performed for the financial and economic system to operate efficiently
 - Significant costs arise if it is not performed
 - Criticality is situation-dependent
- Form (whether provided by a regulated, unregulated entity, bank, non-bank, etc.) does not matter

- Criteria for assessing the critical nature drawn from Annex 2 to the EU MoU on Cross-border Financial Stability of 1 June 2008)
 - Is access crucial for certain economic agents to carry out their business ?
 - Which economic agents are the main users? What is the level of activity?
 - Are there alternatives available within a reasonable time and at a reasonable cost?
 - Are there links with other parts and if so, how important are those links?

Step 2: Take actions in national jurisdictions to protect functions

- (1) Actions to reduce the likelihood that the provider of the critical function fails
- (2) Actions to ensure the continuity of the function if its provider fails
- (3) Actions to reduce the severity of loss if the provider fails

(1) Reduce the likelihood that the provider of the function fails

- Regulate all systemically important institutions, markets and instruments (G20)
- Hold large (systemically significant) institutions to the highest standards of governance and risk management (G30)
- Increase capital requirements for systemically important institutions (CH)
- Require contingent capital (Huertas, 2009)
- Create utilities: CLS bank and CCP for CDS and OTC derivatives

(2) Ensure the continuity of the function if the original provider fails

- Establish a regime that allows for continuity of critical functions:
 - Create powers to transfer business operations to another private sector provider, a public sector provider or a bridge bank
 - Make critical business-lines separable

(3) Reduce the severity of loss if the provider of the function fails

- Increase the number of suppliers and reduce concentration (Volcker: „*keep banks small enough to fail*“)
- „Risk-proof“ operations by set-off and netting, collateralisation, segregation
- Examine operational structures in the light of resolution
- Require banks to have wind-down plans (see FSF principles for cross-border cooperation on crisis management)

Step 3: Ensure that national approaches are consistent across borders

- Different national approaches for preserving critical functions give rise to competitive distortions
 - Acknowledge home and host country interests and responsibilities in a crisis
 - Find mutually agreeable criteria for systemically relevant functions (cf. EU MoU and FSF Principles)
 - Identify common compatible methods to preserve them and ways to ensure their cross-border application

Actions

- Acknowledge need for a consistent regulatory regime aimed at preserving critical functions.
- Implement measures that safeguard the performance of critical functions
- Work internationally to eliminate cross-border obstacles