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CIRANO: Too Big to Fail Financial Institutions?

Issues for Canadian Regulators

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Too big to fail: The Canadian context

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- Somewhat less of a concern in Canada
- Following the recent financial crisis:
  - No failure of major financial institutions
  - Limited impact on liquidities

Factors explaining the resilience of the Canadian financial system

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- Strong and healthy financial institutions
  - The six largest banks manage 90% of the sector's assets.
  - Strong reliance on traditional banking practices.

- Conservative lending practices, particularly in the mortgage sector
  - In 2006, prior to the crisis, only 5% of mortgage loans were considered at risk in Canada compared with 22% in the U.S.
  - Limited "housing bubble" in Canada and Québec.

Factors explaining the resilience of the Canadian financial system (cont.)

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- Limited use of securitization
  - At the end of 2007, only 25% of Canadian mortgages had been sold through securitization compared with 50% in the U.S.
- High level of cash reserves
  - Canadian financial institutions posted liquidity ratios that were among the highest in the world.

Then why bother?

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- There are reasons to believe that there is a number of systemically important financial institutions / infrastructures in Canada.
- The solid performance achieved by these entities in the recent financial crisis is no guarantee for the future.
- Proposed reforms address issues that are very real in Canada.
- Moral hazard related to systemically important financial institutions must be reduced.

Too big to fail: The role of financial regulators

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- Responsibility for bailing out financial institutions does not rest with financial regulators.
  - The responsibility rest on governments
- However, financial regulators can play a significant role in reducing the moral hazard related to the potential failure of major financial institutions by:
  - Identifying Systemically Important Financial Institutions (SIFIs);
  - Providing adequate supervision of SIFIs.

SIFIs in the context of the too-big-to-fail debate

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- Definition:
  - SIFIs are financial institutions whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity (Financial Stability Board).
- The identification of SIFIs will allow the regulator to put in place adequate regulation and monitoring.
  - The purpose is not to identify institutions that should be “bailed out.”

The Regulators/Safety net players in Canada: Who are they?

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- Bank of Canada
- Office of the Superintendent of Financial Institutions (OSFI)
- Provincial securities regulators
- Canada Deposit Insurance Corporation (CDIC)

The role of the Autorité des marchés financiers (AMF)

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- The AMF is an integrated financial regulator responsible for the supervision of all financial institutions in Quebec, other than federally chartered banks:
  - Québec chartered deposit institutions
  - Insurance companies operating in Québec
  - Securities firms
  - Montréal Exchange, the Canadian Derivatives Clearing Corporation (CDCC)
  - Québec deposit insurance regime

Identification of Systemically Important Financial Institutions (SIFIs)

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- In response to the financial crisis, substantial work has been done to define SIFIs.
- Initial work done by the Financial Stability Board (October 2009) identified four general criteria:
  - Size
  - Interconnectedness
  - Leverage
  - Asset liability mismatch
- Sector-based work done by:
  - the Basel Committee on Banking Supervision,
  - the International Association of Insurance Supervisors, and
  - the International Organization of Securities Commissions

Sector-based approach to defining SIFIs

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Criteria	Global Banks[1] (BCBS)	Insurance Companies (IAIS)	Securities Market (IOSCO)
Cross-jurisdictional activities	x	x	
Size	x	x	x
Interconnectedness	x	x	x
Substitutability	x	x	x
Complexity	x		
Non-traditional insurance activities		x	
Information asymmetry			x

1) Consultation launched in July 2011

Candidates for designation as systemic institutions

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Banking Sector	Insurance Sector	Securities Sector
Large banks and credit unions	Insurance companies involved in non-traditional insurance activities having interlinkages with other financial institutions	Central counterparties (CCPs)
		Financial market infrastructures (FMIs)
		Securities exchanges
		Credit rating agencies (CRAs)
		Auditing firms

Policy framework for reducing the moral hazard of G-SIFIs

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- G-20 Seoul Summit:
  - Effective resolution framework
  - Higher loss absorbency capacity
  - More intensive supervisory oversight
  - Stronger core financial infrastructures

Effective resolution framework

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- This element is key to addressing the “too big to fail” issue.
- Prevent system damage caused by a disorderly collapse without exposing taxpayers to the risk of loss.
- National regime must at the outset provide authorities with the tools to intervene in order to:
  - Ensure the continued performance of the firm's essential financial and economic functions;
  - Sell viable portions of the firm while apportioning losses.
- This is a major challenge.

Effective resolution framework: key elements

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- Strengthened national resolution regimes
  - Designation of a resolution authority with a broad range of powers and tools to resolve a financial institution no longer viable
- Cross-border cooperation arrangements
  - Bilateral or multilateral institution-specific cooperation arrangements that will enable resolution authorities to act collectively to resolve cross- border firms
- Improved resolution planning by firms and authorities
  - Resolvability assessments
  - Recovery and resolution planning (RRP)
- Measures to remove obstacles to resolution

Higher loss absorbency capacity

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- The reforms set forth in Basel III aim at raising, but primarily strengthening, the capital ratios of banks:
  - Microprudential perspective;
  - Strengthening capital: reflects loss experience of larger banks over the past years.

- SIFIs and G-SIFIs should have loss absorbency capacity beyond the minimum agreed Basel III standards:
  - Macroprudential perspective;
  - Additional capital reflects the impact of a SIFI failure on the financial system.

The Basel Committee approach for G-SIBs (Bank G-SIFIs) capital

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- Indicator-based measurement approach to 73 large banks
  - Cross-jurisdictional activity, size, interconnectedness, substitutability, complexity, each with a weight of 20%
  - Possibility of ad hoc adjustments
- G-SIB cut-off point set between 27th and 28th banks
- Minimum additional loss absorbency (common equity as a percentage of risk weighted assets)
  - Five-step scales
  - Minimum additional loss absorbency increases ranges from 1 to 3.5%
- Phase-in between January 2016 and end-2018

More intensive supervisory oversight

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- In the recent crisis, a number of financial institutions failed even though they were assessed by regulators as highly capitalized and highly liquid.
  - Every institution has a unique risk profile.
  - Difficult to rely on a one-size-fits-all minimum capital requirement.
- Role of regulator: maintain an adequate balance between risk taking and capital levels, and intervene if an imbalance arises.
- Given the high cost of recent failures, supervision of SIFIs must be improved.

More intensive supervisory oversight: Selected key elements

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- Early detection and intervention
- Adequate resources
- Improved techniques
- Group-wide and consolidated supervision
- Continuous and comprehensive supervision
- Macroprudential surveillance

Robust core financial infrastructures

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- The recent financial crisis demonstrated the potential for contagion arising from interconnectedness of significant market participants and the limited transparency of counterparty relationships.
- Robust financial market infrastructures make an essential contribution to financial stability by reducing what could otherwise be a major source of systemic risk.

Developing robust financial infrastructures: Key elements

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- Update and strengthen international standards for financial market infrastructures
- National authorities should take measures in line with the G-20 commitment that :
  - All standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties.
  - OTC derivatives contracts should be reported to trade repositories.

Conclusion

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- Improved financial regulation and supervision can reduce significantly the moral hazard related to so-called “too big to fail” financial institutions.