Finance Watch response
to the Financial Stability Board's public consultation on
the evaluation of the effects of "too-big-to-fail" reforms

Brussels, 30 September 2020

Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizen's counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 109 civil society members from 20 different European countries include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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We agree to the publication of this response.

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Q1. Does the report draw the appropriate inferences about the extent to which TBTF reforms have achieved their objectives?

At the Pittsburgh Summit in 2009, G20 Leaders called on the FSB to propose possible measures to address "too-big-to-fail" (TBTF) problems associated with SIFIs. In 2010, at the Seoul summit, the G20 Leaders endorsed the FSB framework for *"reducing the moral hazard of SIFIs"*. In 2012, following the Los Cabos summit, the Chair of the FSB reported in his letter to the G-20 finance ministers and central bank governors on progress in implementing the SIFI framework and the *"importance of ending TBTF"*[1]. Since then, "ending too-big-to-fail" has been used regularly to denote this workstream at the FSB and annual reporting on this topic by the FSB to G-20 leaders has regularly come under this heading.[2] Given the immense and lasting damage inflicted on the general public by the 2007/08 crisis there is no doubt, in our view, that this wording represents the correct interpretation of the underlying policy objective, namely to remove once and for all the implicit guarantee extended by the public to excessively large financial institutions.

In the terms of reference for this present review, however, the objectives of TBTF reforms are to *"reduce the moral hazard risks and externalities posed by these [systemically important] banks, and enhance the ability of authorities to resolve them in an orderly manner ..."*. According to the Consultation Report (pg. 13), the reforms are *"intended to reduce the probability and cost of financial crisis"*. The main policy objective that originally informed this endeavour, and which should be the benchmark of this review – whether the reforms of the past ten years have ended, or are at least expected to end TBTF in the foreseeable future – no longer figures.

Finance Watch is concerned about the shift in semantics from "ending TBTF" back to "addressing TBTF". We appreciate that a degree of semantic ambiguity may have been helpful to facilitate consensus and convenient to maintain political room for manoeuvre in dealing with a complex subject. In the context of trying to evaluate the effectiveness and adequacy of measures taken, such ambiguity does not serve the purpose well. The financial crisis of 2007/08 and its aftermath have demonstrated that there is little public support in most jurisdictions for rescuing privately-owned financial institutions from the effects of a crisis that they have brought upon themselves. Anything short of an unambiguous commitment of policymakers and the FSB to "ending too-big-to-fail" is unlikely to fully restore public trust in the financial system.

Q2. Does the report identify suitable findings for consideration by the relevant policy-making bodies?

As mentioned previously, the report does not conclusively answer the main underlying question: have the TBTF reforms undertaken so far been successful in ending too big to fail"? This question calls for a binary answer. The report contains a wealth of evidence to draw the conclusion that the answer, regrettably, must be "No". Instead, the report places emphasis on progress being made, in terms of capitalisation and resolvability, and the resulting gains in banking sector resilience. Finance Watch does not dispute these incremental gains. We would argue, however, that to provide useful guidance for the political discussion among G-20 leaders, and all other jurisdictions committed to the process of international standard-setting, the report should be more forthright in stating that TBTF reforms have so far not achieved their objective and new initiatives are therefore needed.

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3. Are the analytical approaches used to evaluate the effects of the TBTF reforms appropriate? Are there other approaches to consider?

The Consultation Report rightly mentions that *"State support for failing banks has continued"* and that *"obstacles to resolvability remain"*. It does not, however, consider the possibility that current levels of loss–absorbing capacity required of SIBs may still be insufficient for these institutions to withstand financial distress in all but the most favourable conditions. This applies, in particular, to regulatory capital, which is available at all times, whereas the capacity of bail-inable debt to absorb losses is predicated upon the feasibility of resolution action, especially bail-in (see Q7.)

The report finds that improvements in the capitalisation of SIBs since the crisis, relative to other banks, are *"often not statistically significant"* (pg. 48) and notes that G-SIBs continue to operate with ratios of Tier 1 capital to (unweighted) assets that are significantly lower than those of D-SIBs or non-SIBs (pg. 45). This would imply that the business of G-SIBs is, on average, less risky than that of other banks – a conclusion that is intuitively difficult to accept and empirically unproven at best. Rather to the contrary, G-SIB balance sheets contain comparatively high proportions of Level 2 and 3 assets (28% vs. 15%) and derivatives (8.7% vs. 1.2-2.6%), exposures that tend to be notoriously difficult to value and susceptible to triggering large single-event losses.

The report acknowledges that average risk weights (RWA densities) for G-SIBs *"remain substantially lower for G-SIBs when compared with other banks"* but attributes this finding to *"differences in the business model and the type of activity which the banks engage in"* (Appendix, pgs. 58 and 156). It does not consider the possible explanation, supported by a numerous independent studies[3], that the use of internal risk models – the A-IRB approach under Basel III – enables G-SIBs, in particular, to apply discretionary judgment in valuing certain asset categories, and so to achieve altogether lower RWA densities than banks that rely on . We are mindful that the – now delayed – finalisation of Basel III provides for an "output floor" to address this issue but would nevertheless suggest a more detailed review by the FSB, assisted by the BCBS, of the adequacy of SIB capital levels, in general, and the calibration of G-SIB (and D-SIB) buffers, in particular.

The Consultation Report also highlights the largely unchanged structural and geographical complexity of SIBs, in general, and G-SIBs, in particular (pgs. 47-49). It appears that the FSB's analysis on this point has been limited and hampered by a lack of available data, which could be seen as a concern. Moreover, the analysis does not consider the possible correlation between organisational complexity and the resolvability of SIBs (see Q7. below). We would therefore welcome a more comprehensive analytical review of the impact of organisational complexity on the resilience and resolvability of SIBs, which could in turn provide valuable information to better assess why TBTF reform measures so far have not had a demonstrable effect on the complexity of SIBs.

5. The analysis was carried out before the COVID-19 pandemic, which may have produced new evidence relevant to the evaluation. Within the terms of reference, what updated analytical work would be most useful?

In response to the COVID-19 pandemic, and in with the FSB's recommendations[4], G-20 jurisdictions, and many others, have introduced measures that make use of the countercyclical mechanisms and discretionary flexibility available in their respective prudential frameworks. Finance Watch supports these measures and their objective of avoiding incremental stress and strictures on the banking sector that would likely augment the impact of the external shock caused by the pandemic. Some

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jurisdictions, such as the EU, have also chosen to postpone the implementation of certain parts of the final Basel III framework, as has been suggested by the BCBS.

We observe that there are calls for another review of the final Basel III framework arguing that the impact of the COVID-19 could be mitigated by adopting less demanding prudential requirements, e.g. regarding the output floor for credit risk, the treatment of trading book exposures or operational risk. In the context of this review, whose main finding in our view is that TBTF has not been conclusively addressed and significant further progress ought to be made, we follow this debate with great concern. As discussed previously (see Q3. above), the Consultation Report appears to confirm our view that capitalisation levels for SIBs are still not adequate and should be further strengthened. The finalisation of Basel III, although not sufficient on its own, would be an important step in the right direction and should not be reversed or diluted.

6. Does the report accurately describe the ways in which TBTF reforms may affect banks' behaviour and markets' responses? Are there other channels that the evaluation has not considered?

The impact of TBTF reforms on the functioning of financial markets is difficult to observe because market conditions during the ten-year observation period can barely be described as normal. Throughout this period, the balance of supply and demand has been dislocated by massive central bank interventions. These interventions were the direct result of the 2007/08 financial crisis and, in Europe, the sovereign debt crisis of the Euro area, which peaked in 2012 and was itself a second-round effect of the former. This is to say that the global financial markets have operated for the last ten years in a persistent state of emergency, driven largely by the continuous implementation of unorthodox monetary policy in some of the major G-20 jurisdictions, which have resulted in inflated equity valuations and escalating corporate and household debt levels in a number of these jurisdictions.

The report concludes, in summary, that market shares of SIBs in their domestic markets have declined. It acknowledges, however, that this does not apply to Europe where SIBs have, to the contrary, further increased their share of assets, loans and deposits (pg. 50). Findings in other regions are mixed. The report confirms that the size distribution of banks remains highly skewed in most countries and markets, on the whole, continue to be vulnerable to shocks to these large institutions (pg. 69).). The dynamics that enable SIBs, in general, and G-SIBs, in particular, to further strengthen their market positions, despite the implementation of TBTF reforms, should be further reviewed.

There is evidence that G-SIBs, and some D-SIBs hold dominant market positions in some areas of wholesale banking, in particular, which affect both the competitiveness and, potentially, stability of these markets. In the Consultation Report only the latter is considered. The report finds that interconnectedness between SIBs, directly through interbank lending, trading and investment, and indirectly through membership in Central Counterparties (CCPs) and relationships with Non-Bank Financial Intermediaries (NBFIs), remains very high (pgs. 55 and 57). We agree that further research is needed to better assess the financial stability implications of the increasing involvement of NBFIs in banking and related activities and to create more transparency of the links between banks and NBFIs. We would also welcome a more granular analysis of the development of SIBs' market shares in wholesale banking and capital markets and the impact of what we expect to be a high degree of concentration in key market segments on the competitiveness and stability of global markets.

7. Does the report accurately describe the remaining obstacles to the resolvability of systemically important banks (SIBs)? Are there other major obstacles that should be highlighted?

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Finance Watch agrees with the Consultation Report's conclusion that obstacles to resolvability remain and more needs to be done to remove them (pg. 31). We are aware that many policymakers, academic and professional experts and large sections of the market continue to express serious doubts about the realistic prospects of resolving SIBs, in general, and G-SIBs, in particular, without recourse to public funds. Experience so far has shown that resolution action has been the exception, rather than the rule. Of the five cases of EU banks reviewed in Annex G to the Consultation Report only one, Banco Popular Español, has been resolved so far using the procedure set out in the EU Bank Recovery and Resolution Directive. In all other cases public funds were used once again to stabilise failing banks.

The report correctly identifies a number of obstacles, such as the availability, and appropriate distribution of internal TLAC, the availability of resolution funding arrangements, the need to secure access to financial market infrastructure (FMI), and to conduct a timely, and accurate valuation of a failing bank's assets and liabilities. While all these are valid and important considerations it appears that the report does not take into account that the legal, organisational and operational complexity of SIB groups by itself has the capacity to cause substantial problems in the development of credible, and viable resolution plans and therefore constitutes a major impediment to resolvability. While the FSB's Key Attributes Key Attributes of Effective Resolution Regimes for Financial Institutions (KA) call for supervisory or resolution authorities to be able to impose measures to reduce the complexity and costliness of resolution, including changes to a bank's business practices, structure or organisation (Principle 10.5), it appears that these powers have so far not been used even in jurisdictions, such as the EU, where they have been implemented. The Consultation Report should, in our view, recognise this issue as one of the existing obstacles to resolvability so that policymakers may consider amending the FBS's mandate accordingly.

8. Does the report draw appropriate inferences about the extent to which market participants perceive resolution reforms to be credible?

As the report rightly observes, public support for private-sector banks in jurisdictions that have already introduced comprehensive resolution regimes *"cast doubt on the effectiveness and credibility of those regimes"* (pg. 30).

We would therefore expect that market participants will continue to factor in government support when pricing SIB-issued debt securities. This assumption appears to be confirmed by the findings of the Consultation Report. The report observes that, according to most of the studies commissioned and/or evaluated as part of the review, funding cost advantages (FCAs) of SIBs have declined, on average, since their peak at the height of the crisis but have remained unchanged or even increased relative to the average pre-crisis level (pgs. 33-35). This appears plausible: as memories of the crisis recede and TBTF reforms, especially bail-in, are introduced, market participants are likely to mark down their expectations of sovereign support for SIBs. A moderate decline of FCAs from their mid-crisis peaks should not be seen as evidence, however, that market participants have come to expect that SIBs will be resolved, rather than bailed-out, in a future crisis.

For the purposes of informing the policy discussion going forward the principal finding to be communicated to policymakers is that implicit subsidies (FCAs) still exist and that they are, by all accounts, material. That implies that TBTF continues to distort the pricing of risk, and therefore the competitive environment in favour of SIBs. As we have seen before the crisis of 2007/08, this effect

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tends to be self-reinforcing and further entrenches, if not exacerbates the already existing polarisation of the banking landscape in many jurisdictions (see also Q6. above).

10. Does the report accurately describe changes in the structure and resilience of the global financial system and in financial integration? Does it draw the appropriate inferences about the extent to which these changes have been driven by TBTF reforms? Does the report accurately describe and estimate the social costs and benefits of TBTF reforms?

As mentioned in our response to Q1. we believe that the Consultation Report places too much emphasis on incremental, but ultimately insufficient gains. As a summary of a major international effort that has lasted for ten years and had the explicit support of G-20 leaders, the level of progress achieved so far can only be deemed unsatisfactory. Policymakers should be reminded of their commitment, in the aftermath of the 2007/08 crisis, that TBTF would be ended and that public funds would never again be used to fund a wholesale rescue of the financial sector in general, and banking, in particular, except in the most exceptional circumstances – such as a global pandemic. In order to rebuild public trust in the financial system it is important, in our view, to reiterate this commitment and acknowledge that, for all the welcome progress that TBTF reforms have brought so far, TBTF has not been solved and further regulatory efforts are required at a global scale.

11. Are there any other issues that should be considered, within the terms of reference?

We would like to draw the FSB's attention to the design of the framework for designating G-SIBs, which, although its has so far served its purpose, could benefit from incremental improvements. In particular, we believe that the designation scheme should be reviewed to ensure that the list is consistent over time and reliably covers all institutions that are of global significance.

This is important because a) the implications of being designated as a G-SIB are material for the bank in question and require significant adjustments for it to comply with the additional prudential, reporting and other requirements; and b) these adjustments need time to be implemented. Since 2011, the list of G-SIBs has remained fairly stable in some respects: it usually comprises around 30 groups and includes a group of 'core constituents', in particular in the four higher 'buckets' (2-5), that have been on the list continuously since its inception. We note, however, that there are several banks that have been removed from the list over time but which are, by virtue of their size and geographical presence, still widely recognised by market participants as being systemically important at a global scale. We would recommend a review of the G-SIB designation framework that provides for more continuity over time, e.g. by calculating the relevant quantitative scores over longer reference periods. We appreciate that this could lead to a longer list of G-SIBs overall but believe that a more comprehensive list would also be more stable over time and therefore also better serve the objective of consistency.

There may also be some implicit tension in the current framework between the objectives to capture institutions that have the potential to cause systemic risk across a number of jurisdictions due to their geographical presence and connectedness, on the one hand, and institutions which are comparatively present internationally but whose systemic importance in one jurisdiction, usually its home jurisdiction, is such that it could destabilise the economy of that jurisdiction to the extent that it sets off a regional, or even global chain of "bank-sovereign" contagion. We believe that these objectives should not be viewed as contradictory and amendments of the designation framework should be considered, where necessary, to accommodate both.

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Notes

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