14. Juni 2019

Financial Stability Board

Mrs
Claudia Buch
Vice-President
Deutsche Bundesbank

Re: Evaluation of too-big-to-fail reform

Ref no: 13/2019

Ladies and Gentlemen
Dear Mrs Buch

Since 2007/08 financial crisis significant progress has been made regarding too-big-to-fail reform. Looking from a bird’s eye perspective, major efforts can be divided into three key categories to address counterparty risk:

(1) Transparency/Central Clearing

(2) Capital/Collateralisation

(2) Instant Financial Market Infrastructure.

We would like to focus on the implications of instant financial market infrastructure - FMI (point 6. of your questionnaire: “…other issues relating to the effects of TBTF reforms that are not covered in the questions…”).


Currently, a hybrid system is created. High frequency trading is already standard procedure at many exchanges. Today’s focus: instant payment - transactions executed within seconds, at minimal costs. Regulatory authorities and politics are pushing for fast transition: PSD2, API Hub (Switzerland), etc. to address counterparty risks.

While in the past changes to financial market infrastructure affected financial institutions only: banks, insurance companies, assets managers, etc., current change affect all market participants: governments, private households, non-financial corporations, etc. These participants are not capable of actively managing changes and correlated risks, especially in real-time. In case of future disruptions they will be hit directly: unmuted intensity and speed.

Essentially, there are two ways how automatic, instantaneous spill-over from financial system to non-financial entities can be prevented:

1. instantaneous regulatory intervention

2. real-time insurance similar to firewall
Ad 1:

Countercyclical capital buffers were introduced, are efficient if rule based according to Federal Reserve Bank analysis. Contingent convertible bond is another example for a regulatory tool, which in case of disruption at financial institution level independent if caused internally or externally, automatically acts as countercyclical stabilisation mechanism. The problem of such tools, response times are far too long. It takes months to increase capital standard. And the conversion of convertible bonds is not set-up to be executed within minutes. But the new risk in real-time FMI is the first 90-180 minutes following volatility events. According to central bank analysis, bank-run will take only 30 minutes next, the maximum time available to stabilise financial system and contain fallout is four hours.

Current regulatory set-up and available tools are not sufficient for real time financial market infrastructure.

Ad 2:

If risks are unknown and not quantifiable they can not be managed actively. It is standard procedure to address via insurance cover. Since risk to be covered is financial system and financial institution based, strict conditions have to be adhered to:

- 100% pre-funded, no leverage at all
- Only HQLA accepted by central banks
- Bankruptcy remote accounts/custody
- Access to central bank facilities

Naturally, such an insurance cover can not be provided by a financial institution, neither bank nor insurance company, since both are part of the financial system, and would also become systemic risk due to connectivity and size. Today solution is easy: insurance market, central clearing, and platform based = part of digitization.

Base structure of such insurance can be executed within existing rules & regulation, see for example KLF. Plus, insurance cover is available to governments, financial institutions and non-financial corporations, market is decentralised, costs are widely spread and are sustainable over the whole economic/credit cycle.

Fully integrated insurance allows instant payout, 24/7/365.

Insurance objective is not to cover losses of an insurance/volatility event, but to bridge time gap, give insured entities and/or regulatory authorities enough time to analyse situation and implement lasting measures if needed.

Cost of regulation:

Under self-regulatory regime day-to-day costs are negligible, but in case of a crisis gigantic. Basel III regulation is more expensive on a day-to-day basis, but therefore lower costs in case of a crisis. Hybrid structure next is the most expensive alternative, since costs are high on a day-to-day basis, and following a crisis. Currently, non-financial corporations don’t trust financial system, financial institutions, and financial regulation. In preparation for the next major failure individual buffers of non-operating liquidity reserves have been built, at the cost of about 0.5% lower annual economic growth rate. Plus, liquidity is not even a credible, lasting solution, is inherently risky as well: interest rate, currency, counterparty, etc.

Insurance cover most cost efficient way of protection in an instant financial market infrastructure environment.

Summary:

Regulatory changes so far have made significant progress addressing too-big-to-fail. What is missing is coverage of the risks due to instant financial market infrastructure. Currently a hybrid structure is established: regulation is analogue while financial markets are digitized. Easy and cost efficient way to close the gap is insurance cover. Pre-condition to implementing insurance such as KLF is unbundling of FMI providers, similar to conversion in the banking sector (PSD2, API Hub), removing artificial barriers to market entry.

Yours sincerely,

Manfred E. Will
Founder & CEO