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Systemically important banks and how to deal with them

The financial crisis has shown just how important a stable global financial system is. The failure of Lehman Brothers in September 2008 made clear that the financial distress of a single market participant can cause even global turmoil. This is why the state is forced to weigh up whether letting an institution fail or rescuing it is preferable in macroeconomic terms. As a result, systemically important financial market participants enjoy an implicit state guarantee that they will be bailed out – generally with the taxpayer's money – if they become distressed. During the crisis, both banks and insurance companies were consequently supported through huge capital injections and guarantees.

Systemic importance poses two main problems: firstly, the implicit state guarantee creates incentives for excessive risk-taking (moral hazard problem) and, secondly, the imminent failure of systemically important market participants can put whole economies in serious financial trouble – take Ireland, for example.

Financial Stability Board proposals

The international community therefore rightly wants to mitigate the consequences of the collapse of a systemically important market participant and at the same time price the economic advantages of systemic importance. The G20 has mandated the Financial Stability Board (FSB) to draft tougher supervisory measures for systemically important financial institutions (SIFIs).) zu entwickeln. The FSB's policy framework recommendations include, inter alia, the creation of an effective resolution regime, higher loss absorbance capacity beyond the minimum agreed Basel III standards and more intensive supervisory oversight for SIFIs. In addition, further prudential measures such as liquidity surcharges

A brief word

"Systemic importance" is a term with which few people were familiar before the onset of the financial crisis. It is in the meantime widely used, simultaneously raising the question of how we should handle systemically important financial market institutions (SIFIs). There is no doubt that every financial institution, no matter how big or important, must be allowed to fail without seriously disrupting a national economy or even the global economy. Anything else would not be fully consistent with market principles.

The Financial Stability Board and Basel Committee on Banking Supervision initiatives currently under discussion call for further capital surcharges for SIFIs; more capital is no universal solution, however. Separate rules for SIFIs are not the answer: they distort competition, hamper national economic performance and ultimately do not help to prevent future crises.

Besides, there is already a systemically sound approach: in the Restructuring Act, we have found a good solution in Germany, one that that can also serve as a model to other countries. It allows the resolution of SIFIs as well while at the same time sparing the taxpayer.

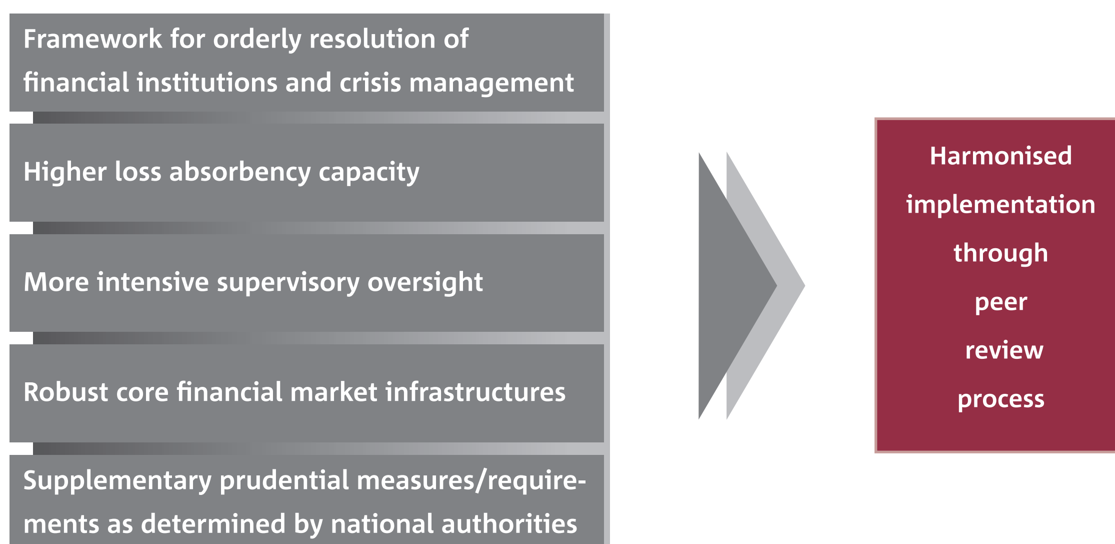
Michael Kemmer
General Manager

and tighter large exposure restrictions, or systemic levies (e.g. a levy on banks), and structural measures such as restrictions on activities and legal form could be adopted. The recommendations are to initially apply only to financial institutions classified as systemically important for the global financial market (global SIFIs, or G-SIFIs for short) and later to cover also national SIFIs and other market participants such as insurance companies and non-banks. Which institutions ultimately figure in the list of relevant G-SIFIs is something that is to be decided by the middle of the year.

A "SIFI list" blurs an eye for actual risks

The FSB and the Basel Committee on Banking Supervision now face the tricky task of identifying global SIFIs. A look at the past shows that it is extremely difficult to recognise systemic importance with absolute certainty in advance. Even during the financial crisis, the systemic importance of many institutions only became clear once they were distressed. Restricting the regulatory framework to banks is too short-sighted an approach. Instead – as envisaged by the FSB in the long term – it should be widened to cover other major financial market participants (insurance companies, hedge funds). However, there are legitimate doubts about whether drawing up a list of G-SIFIs and subjecting these institutions to tougher regulatory requirements is the right course. In particular, objective criteria for measuring systemic importance are still missing. Size, it is now generally agreed, is not the sole deciding factor. After all, it was by no means the really big players that triggered or fuelled the financial crisis. On the contrary, HRE's total assets were, for example, merely a quarter of the largest German bank's. But even much smaller institutions with virtually the same business model and business strategy, such as the savings banks and the cooperative banks, pose a threat to the stability of the financial system if they all get into trouble at once – they are then "too many to fail".

Key points of the FSB policy framework



Market conditions also play a role: in an unstable market environment any market participant can potentially trigger a systemic crisis. A SIFI list thus suggests a level of security that effectively does not exist: instead, it harbours the risk that actual systemic risk will not be taken into account sufficiently in supervisory practice. In addition, such a list may well lead to distortions of competition: institutions which are systemically important but which, for methodological or political reasons, do not appear on the list will not be subject to the tougher SIFI rules. At the same time, institutions that are on the list could be branded as particularly risky and avoided by investors/depositors.

More capital is no universal solution

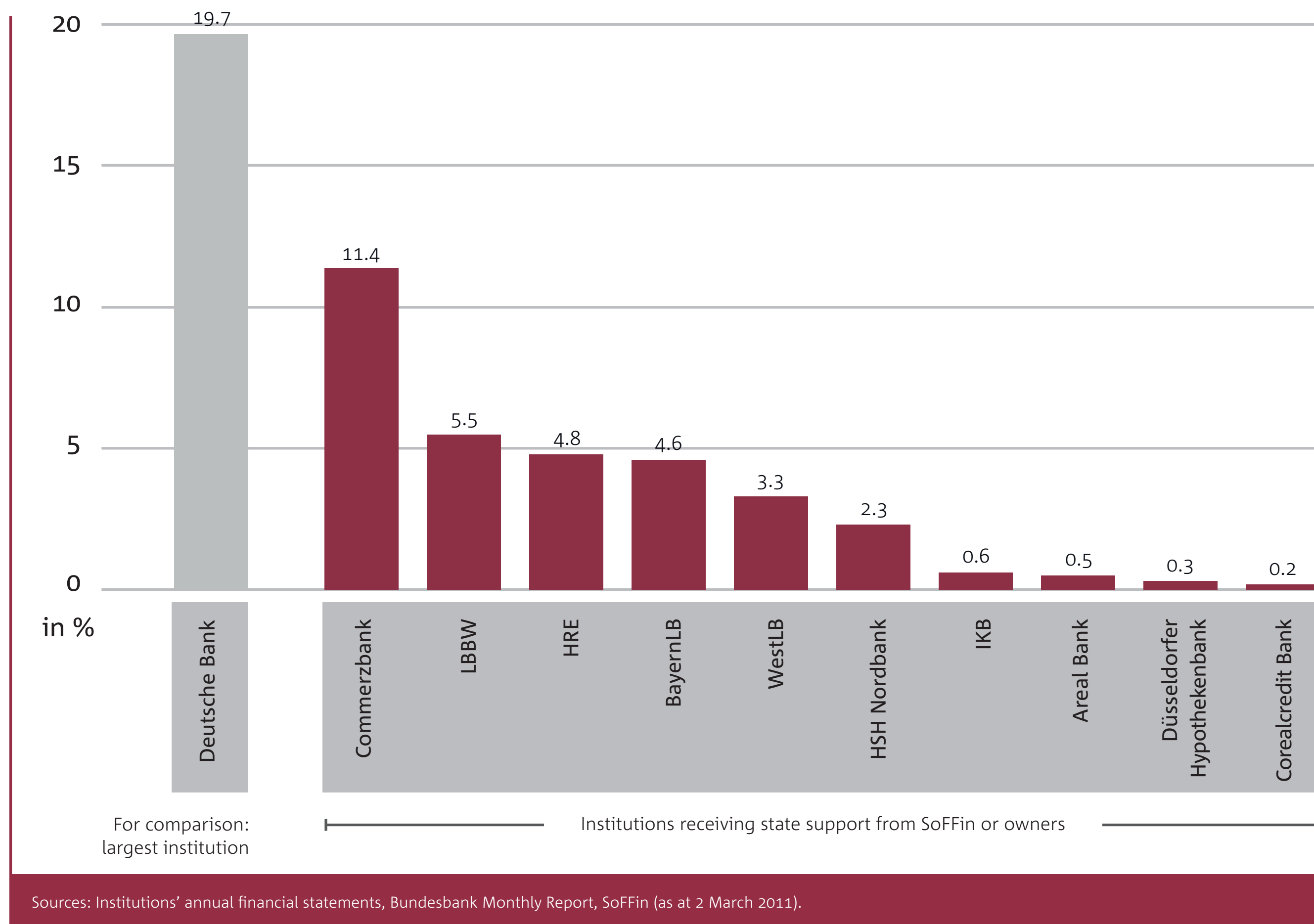
Besides the fact that, following Basel III, the burden on the financial sector has now reached breaking point, there are also theoretical arguments against the introduction of capital surcharges solely for SIFIs. It was not, for example, inadequate capital buffers but the lack of mutual trust among market participants that fuelled the financial crisis. When Lehman Brothers crashed, it had a Tier 1 capital ratio of 11% – even a 2% higher minimum capital level would probably not have been able to avert its failure. On the other hand, the buffering effect of capital is overestimated, as using a capital buffer produces an immediate market response and may prompt a loss of confidence and thus a refunding squeeze. Ultimately, it remains to be seen whether, given that an institution's owners regularly expect a satisfactory return on equity, the price for higher capital ratios is not riskier business. If capital surcharges are nevertheless imposed, banks should not all be lumped together: instead of a "one-size-fits-all" approach, surcharges should be determined by the amount of systemic risk carried by an institution. Systemic levies, such as a bank levy, should also be duly taken into account.

Orderly market exit also for SIFIs – at no burden to the taxpayer

Along with more intensive supervisory oversight for SIFIs, an effective crisis prevention and management mechanism is the best tool for averting future crises. This includes authorising supervisors to intervene at an early stage and

“Size” is not the sole deciding factor

Share of total assets in German market as a whole in 2009



Sources: Institutions’ annual financial statements, Bundesbank Monthly Report, SoFFin (as at 2 March 2011).

oversee the orderly withdrawal from the market also of SIFIs, without any consequences for taxpayer if possible. Entrepreneurial failure must ultimately always to lead to market exit. In the Restructuring Act, which came into force at the turn of the year 2010/2011, Germany haspresented a satisfactory solution. This Act also provides for the establishment of a restructuring fund for SIFIs that is to be financed by a bank levy. Fund contributions will be geared to systemic risk, thus achieving a steering effect at the same time. To avoid any distortions of competition and regulatory arbitrage in the future, an internationally coordinated approach is essential, however.

Course has been set for more financial market stability

It is by all means right and proper to plug regulatory gaps and put financial market stability on a more solid footing. Countries should not be vulnerable to blackmail for financial support. The successful establishment of an international framework under which financial distress also of SIFIs can be addressed through an appropriate resolution regime and cross-border cooperation will be a major step forward.

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