PROMONTORY Sightlines INFOCUS
promontory.com NOVEMBER 17, 2011

FSB Constructs Elaborate SIFI Architecture

BY SUSAN KRAUSE BELL

KEY FSB ACTIONS

- **G-SIBs:** Established criteria for determining globally systemically important banks (identifying 29 of them on a preliminary and nonbinding basis) and agreed upon a capital-surcharge framework for them.
- **G-SIFIs:** Completed policies for recovery and resolution plans and resolvability assessments required for global systemically important financial institutions, and established a timetable for the completion of institution-specific, cross-border cooperation agreements.
- **SIFIs:** Finalized the attributes of resolution regimes and prioritized steps to improve the intensity and effectiveness of supervision for all SIFIs.

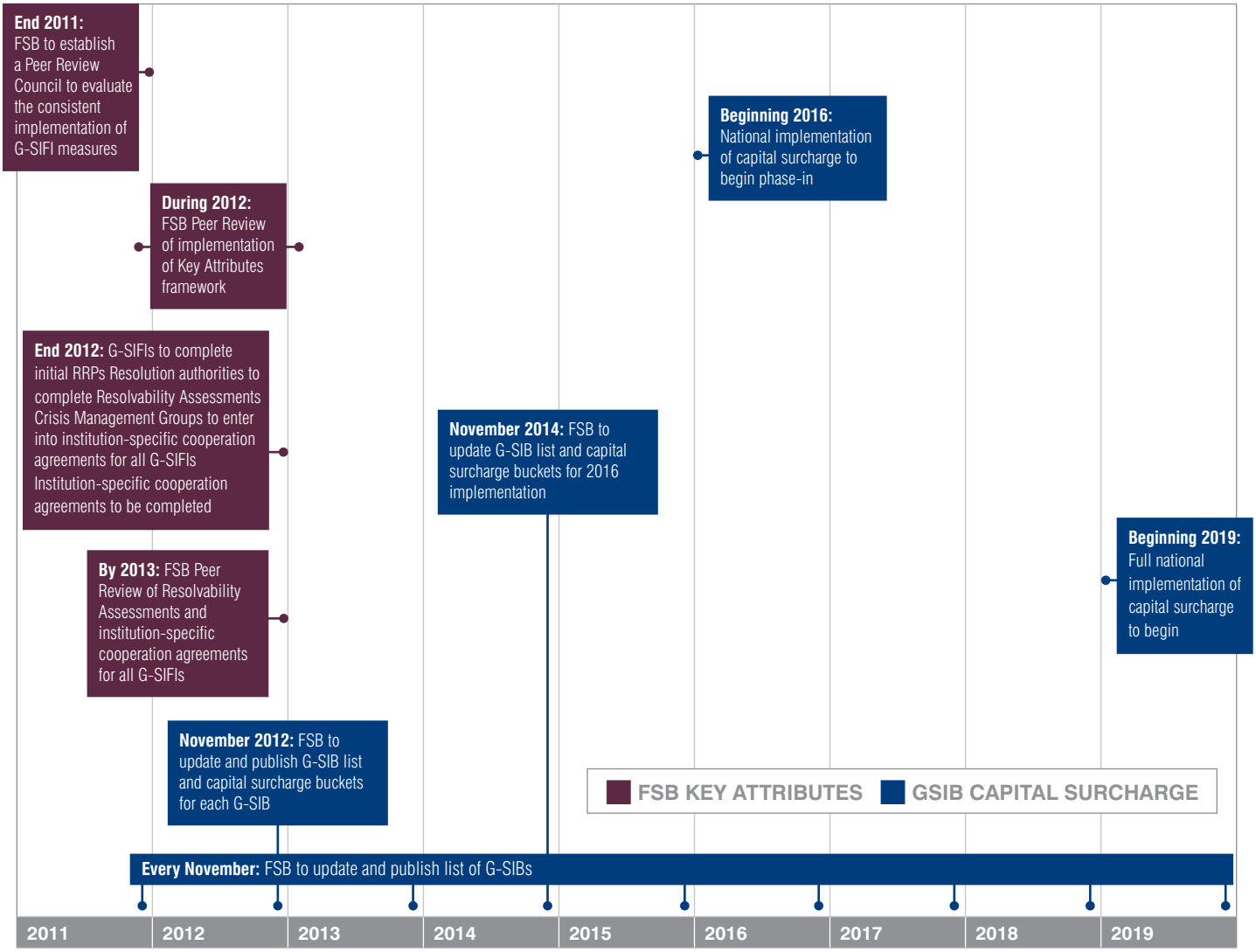
Global banks are understandably eager for a better sense of the international regulatory regime slowly emerging from the global financial crisis, as it carries substantial implications for the way they do business. On the heels of the G20 Leaders Summit in Cannes, France, the Financial Stability Board issued a comprehensive set of policies for systemically important financial institutions — SIFIs. These policies, which had already been published in various stages of development, establish a complex and deeply interconnected architecture to govern the systemic risk posed by SIFIs. Each global firm (particularly those known as global SIFIs, or G-SIFIs), its home- and host-country regulators, and its resolution authorities all have key new roles in limiting both the likelihood and the impact of the firm's failure. This new global architecture, which is still being built, underscores just how seriously policymakers take the commitment to dismantle the "too big to fail" regime and eliminate moral hazard from the financial system.

The major FSB releases include:

- A final framework issued by the Basel Committee on Banking Supervision for the additional capital required of G-SIFIs that are banks, or G-SIBs.[1] The framework also includes the methodology for deciding which global banks will be considered G-SIBs.
- The list of the 29 global banking companies in the initial group of G-SIFIs.[2]
- A final policy framework on resolution regimes ("Key Attributes") that G20 countries are required to implement in order to resolve SIFIs effectively.[3]
- A final policy framework for supervising SIFIs.[4]

[1] BCBS, "Global systemically important banks: assessment methodology and the additional loss absorbency requirement – Rules text and Cover note" (Nov. 2011), available at http://www.bis.org/publ/bcbs207.htm.
[2] FSB, "Annex to Policy Measures to Address Systemically Important Financial Institutions" (4 Nov. 2011), available at http://www.financialstabilityboard.org/publications/r_111104bb.pdf.
[3] FSB, "Key Attributes of Effective Resolution Regimes for Financial Institutions" (4 Nov. 2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.
[4] FSB, "Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision" (27 October 2011), available at http://www.financialstabilityboard.org/publications/r_111104ee.pdf.

IMPLEMENTATION TIMELINE



IDENTIFYING SIFIS

SIFIs are financial institutions whose distress or disorderly failure, because of their size, complexity, and interconnectedness, would cause significant disruption to the wider financial system and economic activity. According to FSB definitions, if the ramifications of a SIFI's distress or disorderly failure occur across a range of countries, it is a G-SIFI. If a G-SIFI is a banking group, it is a G-SIB.

The FSB has given priority to developing a policy framework for G-SIFIs because of the heightened risk they pose to the global financial system, with initial emphasis on G-SIBs. The FSB tasked the Basel Committee to develop a methodology to identify G-SIBs and assign a capital surcharge commensurate with their systemic risk. In the coming year, the FSB will also review the recommendations of the International Association of Insurance Supervisors for identifying global systemically important insurers, but it is not clear how and whether the FSB will identify other nonbank G-SIFIs.

The FSB will continue to have a major role in G-SIFI policy through an international Peer Review Council that will conduct regular reviews of how G-SIFI measures are being implemented. Though

GSIBs

(Global Systemically Important Banks)

Designated by FSB jointly with national authorities and the Basel Committee; all GSIBs are GSIFIs

GSIFIs

(Global Systemically Important Financial Institutions)

Designated by the FSB jointly with national authorities and relevant international standards-setting bodies; the GSIFIs designated by FSB thus far are all GSIBs

SIFIs

(Systemically Important Financial Institutions)

National authorities designate SIFIs if systemic impact is not global

FSB members have agreed that many of the policies also apply to SIFIs, it appears that national supervisors will have more discretion in both identifying SIFIs and in implementing the policies.[5]

G-SIB CAPITAL SURCHARGE REQUIREMENT

The Basel Committee's framework for additional loss absorbency — commonly called the capital surcharge — is aimed at reducing the probability that a G-SIB will fail. The Basel Committee and the FSB intend the surcharge to complement FSB policies on improving resolution regimes, which are aimed at reducing impact should a failure occur. The Basel Committee issued the surcharge framework as a consultative document in July and the final agreement did not change significantly.[6]

Methodology to Measure Systemic Importance

As in the proposed version, the methodology to determine systemic impact is a multiple-indicator-based measurement approach, supplemented by supervisory judgment subject to international peer review. The Basel Committee selected five equally weighted categories for determining systemic importance: size, interconnectedness, lack of ready substitutes, global activity, and complexity. Supervisory judgment would overlay these indicators.

INDICATOR-BASED MEASUREMENT APPROACH

CATEGORY (each weighted 20%)	INDIVIDUAL INDICATOR	INDICATOR WEIGHTING
CROSS-JURISDICTIONAL ACTIVITY	Cross-jurisdictional claims	10%
	Cross-jurisdictional liabilities	10%
SIZE	Total exposures as defined for use in the Basel III leverage ratio	20%
INTERCONNECTEDNESS	Intra-financial system assets	6.67%
	Intra-financial system liabilities	6.67%
	Wholesale funding ratio	6.67%
SUBSTITUTABILITY/ FINANCIAL INSTITUTION INFRASTRUCTURE	Assets under custody	6.67%
	Payments cleared and settled through payment systems	6.67%
	Values of underwritten transactions in debt and equity markets	6.67%
COMPLEXITY	OTC derivatives (notional value)	6.67%
	Level 3 assets	6.67%
	Held for trading and available for sale value	6.67%

Source: Basel Committee on Banking Supervision

[5] In the U.S., the Dodd-Frank Act requires the Financial Stability Oversight Council to identify nonbank companies for Federal Reserve supervision if it finds that they could pose a threat to financial stability. It also requires the Federal Reserve to establish heightened prudential standards for such companies, as well as for bank holding companies with $50 billion or more in assets. This has created some confusion because it is an approach similar to the FSB's framework, but the companies subject to Dodd-Frank's heightened standards will not necessarily be SIFIs as defined by FSB. Rather than identifying SIFIs, Dodd-Frank subjects institutions to a set of prudential standards that gradually increase in stringency depending on the institution's size and interconnectedness, among other measurements of an institution's perceived threat to financial stability.

[6] BCBS, "Global systemically important banks: Assessment methodology and the additional loss absorbency requirement" (July 2011), available at http://www.bis.org/publ/bcbs201.pdf. For a summary see Promontory Sightlines Alert July 21, 2010.

Each of the five categories consists of multiple indicators that are weighted equally within each category (see table above). To determine scores for each bank, the Basel Committee selected a sample of 73 global banks and essentially compared each bank against the whole group. That is, for each bank, the Basel Committee calculated the score for an individual indicator by dividing the value of the indicator for the individual bank by the aggregate value of the indicator for all banks in the sample. The indicator weighting is then applied to each score. Adding together the weighted scores of all of a bank's individual indicators yields the bank's overall score.

The Basel Committee agreed to make some relatively minor changes based on comments to July's consultation paper, including wording clarifications in the names of the categories and indicators. More substantively, the committee tentatively agreed to make the following changes — and test them over the next several months — though they are not yet reflected in the written text of the framework.

- Replace "Wholesale funding ratio" as an indicator of interconnectedness with "marketable securities issued by banks" and consider focusing on maturities of one year or less.
- Collect payments data from banks on a currency basis rather than a payment-system basis.
- Remove from the "Trading book value and available for sale value" indicator those assets considered high-quality liquid assets under the liquidity coverage ratio.

Assignment of Capital Surcharge

Despite the concern of many commenters about the size of the capital surcharge, the Basel Committee did not change its approach. The committee will assign G-SIBs to four "buckets" of systemic importance based on the outcomes of the indicator-based measurement approach. Each bucket will have a corresponding capital requirement that will have to be met with common equity as defined by the Basel III framework. The additional capital requirement will be implemented through extending the capital-conservation buffer that is required as part of tier 1 capital in the Basel III framework.

The four buckets require capital ranging from 1.0% to 2.5% of risk-weighted assets, with a 3.5% bucket as an upper limit that is designed to be empty at implementation. G-SIBs that progress to a bucket requiring additional capital must meet the new level within a year. Banks that fail to do so will fall under the capital-retention mechanism of the expanded capital-conservation buffer described in the Basel III framework. The bucketing approach would be structured as follows:

CAPITAL SURCHARGE REQUIREMENTS

BUCKET ASSIGNED TO G-SIB	MINIMUM ADDITIONAL CAPITAL (common equity as a percentage of risk-weighted assets)
5 (empty)	3.5%
4	2.5%
3	2.0%
2	1.5%
1	1.0%

Source: Basel Committee on Banking Supervision

Applying the Methodology over Time

The Basel Committee selected its initial list of G-SIBs by analyzing the scores of the 73 banks in the sample and selecting a cut-off score. The FSB has endorsed the initial list of 29 banks, 27 of which were above the selected cut-off, and two unidentified banks added to the list at the request of their home-country supervisors (see Annex for the list). The list will be updated every November based on new data, and G-SIBs can migrate on or off the list. Beginning in November 2012, the published list will also show each G-SIB's preliminary bucket assignment and corresponding capital surcharge. The assignment is for planning purposes only because a firm's bucket may change prior to implementation.

The additional loss-absorbency requirement will be phased in at the same time as the Basel III capital conservation and countercyclical buffers, i.e., beginning January 1, 2016 and becoming fully effective on January 1, 2019. The FSB will use year-end 2013 data to determine the final list of banks that must prepare for 2016 implementation, including their capital bucket. It will release the list in November 2014, along with the cut-off score, the threshold scores for buckets, and the denominators used to normalize the indicators.

IMPROVING RESOLUTION REGIMES

The main thrust of the FSB's SIFI policy framework is to improve the resolvability of institutions whose failure could disrupt the financial system or the economy. The FSB's framework set forth in the Key Attributes paper is an ambitious and multifaceted approach to reducing the impact of a SIFI's failure. Certain additional policies also apply primarily to G-SIFIs, including resolvability assessments, recovery and resolution plans (RRPs), and cross-border cooperation agreements. In addition, all member jurisdictions agreed to ensure that their national resolution regimes meet certain standards designed to resolve failing financial firms in an orderly manner.

Recovery and Resolution Planning

One aspect of the Key Attributes paper finalizes the FSB's requirements for recovery and resolution plans. RRPs have received considerable attention from the industry, particularly in the United Kingdom, United States, and other countries where national implementation has begun. Under the FSB policy, members agree to put in place processes for recovery and resolution planning for all institutions that could have an impact on financial stability if they fail. The FSB agreed that G-SIFIs would be required to submit their RRPs by December 2012, but was silent on whether other SIFIs have a deadline.

RRPs are designed to be a supervisory tool, where firms and supervisors work together to plan actions that would be taken in times of financial difficulty, and identify and remove obstacles to orderly resolution should it become necessary. The recovery plan is institution-driven, focusing on steps that management would take to reduce risk and conserve capital in times of severe stress. In contrast, the resolution plan is driven by the supervisor, although the firm is responsible for providing the necessary input. The RRP should be developed by senior management, subject to a strong governance structure, updated annually or in the event of a material change, tailored to the firm's structure and business plan, and integrated with other key firm processes such as risk management and contingency planning.[7] The FSB guidance laid out the elements that should be included in the RRP, which are summarized in the following table. Many jurisdictions have issued specific, more detailed requirements that are consistent with those below.

[7] See "Recovery and Resolution Planning: Some Practical Considerations," Promontory Financial Group LLC and Sullivan & Cromwell LLP, November 2011.

SUMMARY OF ESSENTIAL CONTENTS OF FSB RECOVERY AND RESOLUTION PLANS

COMMON ELEMENTS OF RECOVERY AND RESOLUTION PLANS	
SUMMARY	• Recovery or resolution strategy, as applicable • Identification of firm's essential and systemic functions • Potential obstacles to implementing strategies and actions to mitigate those obstacles
STRATEGIC ANALYSIS	• Mapping of essential and systemic functions to legal entities • Actions to maintain funding for essential and systemic functions • Analysis of viability of separable entities and of the impact of separation on the remaining group • Assessment of likely effectiveness and risks for customers, counterparties, and market confidence or each material aspect of the recovery or resolution plan • Underlying assumptions in the plan • Potential impediments to execution of the plan • Processes for determining values of assets and operations
INFORMATIONAL REQUIREMENTS	• Intra-group inter-linkages between business lines, legal entities, and jurisdictions • Intra-group exposures, including guarantees and loans • Dependencies of legal entities on other group entities • Operational data • Information on operations that support recovery or resolution measures • Information on payment, clearing, and settlement systems • Inventory of key management-information systems • Crisis management roles and responsibilities and procedures for providing information to relevant authorities • Legal and regulatory environment in which the firms operate
ELEMENTS OF RECOVERY PLANS	

	• Possible recovery options to restore viability under both idiosyncratic and market-wide stress scenarios:
	  • Capital building and conservation steps
	  • Sales of subsidiaries or business units
	  • Voluntary restructuring of liabilities
	  • Funding measures
	• Contingency arrangements for internal processes, IT, vendor, and employee contracts during recovery actions
	• Implementation triggers for recovery actions, including prerequisites for actions
	• Strategy for communication to all stakeholders

ELEMENTS OF RESOLUTION PLANS (to be completed by authorities)	
	• Regulatory and legal conditions for initiation of official actions • Suitable resolution options to preserve essential and systemic functions and wind down others • Actions to protect insured depositors and insurance policy holders and ensure the rapid return of segregated assets • Impact of resolution actions, including on business lines, legal entities, financial contracts, markets, and competitors • Resolution funding options • Plans for supporting the continued operation of the firm's critical functions • Processes for cross-border implementation of the plan

Supervisory Coordination

At least for G-SIFIs, the home resolution authority is expected to take the lead in development of the group resolution plan in coordination with all members of the firm's Crisis Management Group (described further below). Officials at home and relevant host authorities should review resolution strategies at least annually. The FSB policy states that reviews should include the firm's CEO.

Resolvability Assessments

The FSB agreed regulators should undertake resolvability assessments for all G-SIFIs, which are closely related to — but distinct from — RRPs. Resolvability assessments evaluate the feasibility of resolution strategies and their credibility in light of the likely impact of the firm's failure on the financial system and the overall economy. The home-country authority has the obligation to conduct the group resolvability assessment in coordination with the crisis-management group. Resolvability assessments should inform a firm's recovery and resolution planning.

Without question, resolvability assessments and the resolution plan portion of the RRP have some redundancies. However, the resolvability assessment takes into account factors exogenous to the firm, such as resolution regimes in the group's operating jurisdictions and the capacity of the relevant authorities. It also focuses authorities on the actions they want the firm to take in order to improve its resolvability. There are three stages:

- Assessing the feasibility of resolution strategies;
- Assessing the systemic impact of failure; and
- Identifying actions to improve resolvability.

FACTORS THE AUTHORITIES ARE SUPPOSED TO CONSIDER INCLUDE THE FOLLOWING:

STAGE 1: FEASIBILITY OF RESOLUTION STRATEGIES	Assessment of: • Firm structure and operations • Internal interconnectedness • Membership in financial-market utilities • Management information systems
STAGE 1: ASSESSMENT OF SYSTEMIC IMPACT OF FAILURE	Impact on: • Financial markets • Financial-market utilities • Funding conditions • Capital • Economy
STAGE 3: ACTIONS TO IMPROVE RESOLVABILITY	Determine based on stage 1 & 2 assessments whether changes to the firm's RRP, structure, and operations are necessary to make the resolution plan feasible and credible.

The resolvability assessments and the actions flowing from them should be a continuous process. While overlapping with the RRP, resolvability assessments should provide regular input into resolution planning.

Crisis-Management Groups and Cross-border Cooperation Agreements

The FSB requires member countries to establish firm-specific Crisis-Management Groups ("CMGs") consisting of supervisory and resolution authorities, central banks, finance ministries, and public

authorities responsible for relevant guarantee schemes. CMGs should develop, execute and may make public (at least in broad structure) firm-specific, cross-border cooperation agreements. These agreements will identify responsibilities of home and host authorities. They will also establish information-sharing frameworks and, of import to regulated entities, confidentiality measures and obligations. These latter may include, for example, limiting supervisory personnel with access to data and requiring applicable personnel to execute confidentiality agreements. In all cases, however, top officials of relevant home and host authorities should have access to information relevant for recovery and resolution planning as well as for resolution itself.

While these agreements will generally require home and host authorities to resolve firms with the aim of protecting stakeholders in all jurisdictions, the agreements do permit host authorities to act independently if necessary to achieve domestic financial stability – for example, with respect to the resolution of a foreign branch.

Resolution Regimes

The FSB defines the trigger for resolution as the point at which a firm is no longer viable or is unlikely to remain viable, with no reasonable prospect of becoming so. The FSB recognizes the trigger is vague, and will explore whether it can provide additional detail on suitable criteria for judging non-viability. The resolution regime envisioned by the FSB generally respects the established hierarchy of claims, ensures no creditors will be worse off in resolution than they would be in liquidation, and prohibits national laws from discriminating against creditors (including depositors) on the basis of nationality, location of claim, or jurisdiction where such claim is payable.

The FSB provides an extensive list of powers that should be available to resolution authorities, including "bail-in" strategies that capitalize a newly established entity or bridge institution to which certain essential functions are transferred. However, the FSB is very clear that no particular resolution strategy is favored or afforded a special status, including bail-ins or bridge institutions. The FSB also does not identify the types of liabilities that should be subject to bail-in, but emphasizes that, in any outcome, the hierarchy of claims should be respected.

Resolution authorities should also establish privately financed deposit insurance, resolution funds, or an ex post funding mechanism to recover the costs of providing temporary financing for a firm in resolution. Although not required, the FSB permits resolution authorities to nationalize firms as a last resort. While the FSB recognizes the importance of liquidity-support arrangements provided by central banks in the resolution context, it has not yet identified a preferred arrangement point. Instead, the FSB intends to assess whether more guidance is warranted as funding arrangements emerge over time.

MORE INTENSIVE AND EFFECTIVE SUPERVISION OF ALL SIFIS

The FSB also issued a report on the progress of national supervisors in implementing the recommendations the FSB made a year ago for enhanced supervision of SIFIs.[8] Supervisors have made progress in addressing many of the FSB's recommendations, including those related to model-risk management, enhanced board and senior management scrutiny, increased emphasis on adoption of strong controls by SIFIs, deep dives and horizontal reviews, stress testing, supervisory colleges, macroprudential surveillance, and examination of business-model-specific risks. However,

[8] See FSB, "Intensity and Effectiveness of SIFI Supervision: Progress report on implementing the recommendations on enhanced supervision" (27 Oct. 2011); FSB, "Intensity and Effectiveness of SIFI Supervision: Recommendations for enhanced supervision" (2 Nov. 2010), available at http://www.financialstabilityboard.org/publications/r_101101.pdf.

inadequate information systems and data architectures at SIFIs and resource constraints among supervisors are impeding progress on a number of issues. Specifically, inadequate IT systems hinder risk management practices (e.g., stress testing), implementation of effective risk-appetite frameworks, supervisory oversight, and other global initiatives (e.g., resolvability, shadow banking monitoring frameworks, legal entity identifiers, etc.). The FSB also observed a widespread lack of supervisory capacity and talent to handle increased expectations and unexpected problems.

Based on these findings, the FSB said:

- It will develop supervisory expectations for data-aggregation capabilities, particularly for SIFIs, that G-SIBs will need to meet by the beginning of 2016.
- It will complete a deeper dive into the adequacy of supervisory resources by year-end 2012.
- Its Supervisory Intensity and Effectiveness Group will issue another report by year-end 2012 on implementation progress to date and will include additional recommendations for supervision.
- It will conduct a thematic review on risk governance at firms, focusing on the risk committee and risk-management functions as well as the supervisory-assessment methodology for risk governance.
- The Basel Committee should review its 2008 report on "External Audit Quality and Banking Supervision" in light of external auditors' deficiencies during the financial crisis.[9]

CONCLUSION

Although much work remains, it is clear that the post-crisis supervisory regime for global institutions will be driven in significant part by the FSB agenda, which is still evolving and is dependent on a complex network of supervisors and other government officials. The FSB has an ambitious agenda for resolving the too-big-to-fail problem, while national legislators also remain active in passing laws in the wake of the financial crisis and national supervisors are using their powers to intensify their oversight of systemically important firms. 2012 promises to be an extremely challenging year for global financial institutions.

Susan Krause Bell is a managing director at Promontory Financial Group LLC, and advises institutions on enterprise risk management, corporate governance, and regulatory reform. Email her at skrausebell@promontory.com.

[9] See BCBS, "External audit quality and banking supervision" (December 2008), available at http://www.bis.org/publ/bcbs146.pdf.

ANNEX: LIST OF G-SIBS

This list, based on the methodology in the Basel Committee's G-SIB framework document and adopted by the FSB, represents the global banks that would be selected to be G-SIBs based on 2009 data. As expected, all of the global systemically important financial institutions, or G-SIFIs, designated by the Financial Stability Board are global systemically important banks, or G-SIBs. The FSB plans designations of nonbanks at a later date. The FSB's methodology is based on 2009 data, and the list will be updated annually. While the capital surcharge will apply only to those G-SIBs identified in the November 2014 update, the institutions on this initial list must meet FSB's resolution-related requirements for G-SIFIs.

FINANCIAL STABILITY BOARD'S INITIAL G-SIFI/G-SIB DESIGNATION	
Bank of America (U.S.)	JP Morgan Chase (U.S.)
Bank of China (China)	Lloyds Banking Group (U.K.)
Bank of New York Mellon (U.S.)	Mitsubishi UFJ FG (Japan)
Banque Populaire CdE (France)	Mizuho FG (Japan)
Barclays (U.K.)	Morgan Stanley (U.S.)
BNP Paribas (France)	Nordea (Sweden)
Citigroup (U.S.)	Royal Bank of Scotland (U.K.)
Commerzbank (Germany)	Santander (Spain)
Credit Suisse (Switzerland)	Société Générale (France)
Deutsche Bank (Germany)	State Street (U.S.)
Dexia (Belgium)	Sumitomo Mitsui FG (Japan)
Goldman Sachs (U.S.)	UBS (Switzerland)
Group Crédit Agricole (France)	Unicredit Group (Italy)
HSBC (U.K.)	Wells Fargo (U.S.)
ING Bank (Netherlands)	

Promontory Financial Group, LLC
801 17th Street, NW, Suite 1100, Washington, DC 20006 Telephone +1 202 384 1200 Fax +1 202 783 2924 promontory.com