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Basel III and Beyond
Systemically Important Financial Institutions (SIFIs)

November 2011

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Introduction

At the 4 November 2011 Cannes Summit, the G-20 endorsed a comprehensive framework to reduce the risks posed by Systemically Important Financial Institutions (SIFIs). This comes shortly after the publication of the package of measures approved by the Financial Stability Board (FSB) to address the 'too big to fail' (TBTF) problem. These policy measures are primarily the result of two consultation documents that the FSB published jointly with the Basel Committee on Banking Supervision (BCBS) in July 2011.

In this briefing, we outline the key policy initiatives relating to global SIFIs, with a focus on global systemically important banks (G-SIBs), and provide our initial thoughts on what these measures might mean for our clients.

Key policy measures

Effective resolution regimes for financial institutions – Establishes a new international standard that sets out the responsibilities, instruments and powers all national regimes should have to enable authorities to resolve failing firms in an orderly manner, and without exposing the taxpayer to the risk of loss ('FSB Key Attributes of Effective Resolution Regimes').

Mandatory resolvability assessments and Recovery and Resolution Plans – An initial group of 29 banks has been identified as G-SIBs, based on the methodology developed by the BCBS. These banks will need to meet **resolution planning requirements by end-2012.** Home and host authorities are to develop institution-specific cooperation agreements and cross-border crisis management groups.

Additional loss absorbency requirements for G-SIBs – Banks that are determined to be globally systemically important under the BCBS methodology as of November 2014, will be subject to a **1%–2.5% capital surcharge above** the minimum capital level, capital conservation and countercyclical buffer requirements introduced under Basel III. This additional loss absorption capacity is **to be met with common equity** and will be **phased-in between 1 January 2016 and 31 December 2018.**

Enhancement of the intensity and effectiveness of supervision of all SIFIs – This will include stronger supervisory mandates and higher supervisory expectations for risk management functions, data aggregation capabilities, risk governance and internal controls. Those banks identified as G-SIBs as of November 2014, must also meet the **higher supervisory expectations for data aggregation capabilities by 1 January 2016.**

For G-SIBs, the additional loss absorbency requirement loosely translates into one of two things – raise additional capital, or de-leverage, which may have detrimental consequences for the global economy. At the same time, a significant amount of complex and politically sensitive work will need to be undertaken by national authorities and supervisors to prepare feasible legislative frameworks and credible resolution plans, as well as tools for effective intervention. As a result, the compliance challenge and potentially the burden for ensuring success for these new policy measures, appears to have shifted from the regulated to the regulators. Pressure is now on supervisors across jurisdictions to deliver as the FSB monitors and reports their progress to the G-20. To enable the FSB to play this crucial role for the implementation of financial sector regulation, the G-20 also agreed to strengthen the FSB's capacity, resources and governance.

The new policy measures clearly target the largest, globally most active and systemically relevant banks. However, given the sample of 73 institutions used in the BCBS's assessment methodology, the impact is expected to be far-reaching as large internationally active banks – all potential candidates for G-SIB status – undertake comprehensive reviews of their business models, legal and operational structures and global franchises, and adjust them in response to the measures ahead of the November 2014 deadline. Consequently, reactions by G-SIBs are expected to have both a direct and a knock-on effect on counterparties (banks and non-banks), their customers, shareholders and investors at large. The 'real effect' remains uncertain as the widely anticipated potential de-leveraging and reduction in the SIBs' risk-weighted assets may have a negative multiplier effect on the global economy.

The FSB/BCBS view for regulating SIFIs

A SIFI is any institution that is generally considered to be systemically relevant, so that when it exits the market, it causes a major disruption to the financial system, either in its own home market, or globally, depending on its size and geographic reach. A SIFI's contribution to systemic risk is therefore reflected in the size of its liabilities and the impact its failure may have on markets and the real economy. If an institution is viewed as TBTF, it exacerbates moral hazard concerns. The implicit public guarantee for TBTF institutions is seen as translating into a funding advantage that distorts market competition. SIFIs therefore need to be regulated so that they pay for the 'negative externalities' they create and incentivised to become less systemically important.

Our assessment

A buffer-on-a-buffer: The Committee has maintained its 'buffer-on-a-buffer' approach in determining the safety net for making SIFIs more resilient to financial and economic shocks and, as such, to reduce the likelihood of failure. More capital absorbs more losses in bad times; however, the 'magic number' approach propagates a tick-box compliance mentality rather than support of proactive risk management. The Pillar 1 add-on prescription for SIFIs undermines the need for bank management to think critically about risk management, while the 'one-size-fits-all' approach, even with tiering banks into buckets of systemic importance, is an agnostic approach to the source and concentrations of risks.

A sealed verdict: Although the publication of the first group of 29 banks identified as G-SIBs has now eliminated most speculation around the names and even unveiled a couple of surprises, it is not yet officially known what the additional capital requirement will be for each of these 29 banks. Without full transparency, this could have an effect on the market pricing of securities issued by banks and possibly also affecting capital available to them. The Committee will disclose the cut-off score for a bank to be a G-SIB as well as the threshold scores for the five buckets by November 2014, based on end-2013 data. National supervisors are to implement the additional loss absorbency requirement through an extension of the capital conservation buffer, maintaining the division of the buffer into four bands of equal size (Par.147 of Basel III rules text). It is expected that G-SIBs will start preparing to meet this additional loss requirement sooner rather than later. Banks are likely to operate with a small cushion above the Basel III/G-SIB buffer layers, due to the consequences they may face such as restrictions placed on distributions to shareholders, should the buffer get eroded, or the bank grows in systemic importance.

Qualifying capital: The Committee will continue to review contingent capital and support the use of contingent capital to meet higher national requirements, for example in Switzerland, or as proposed by the UK Independent Commission on Banking. G-SIBs however, will be required to meet their additional loss absorbency requirement with Common Equity Tier 1 (CET1) only. Our estimate of the existing volume of non-core capital in issuance by banks globally today is around USD1.4–1.8 trillion, much if not all of which will need to be refinanced to meet Basel III eligibility criteria. We estimate that around USD1 trillion of this will need to be refinanced in the form of ordinary equity to meet the CET1 requirements, leaving USD 400–800 billion potentially to be refinanced in the form of contingent capital. There is a wide range of issues that need to be determined before contingent capital can become reality. For a detailed discussion on this, please refer to 'The trillion dollar question: can bail-in capital bail out the banking industry?' also published in our 'Basel III and beyond' series.

Economic cost: Banks have a number of options to comply with the new loss absorbency requirement. These include capitalising retained earnings (assuming profitability is maintained), raising new equity, or reducing risk-weighted assets (RWAs), which means reducing trading activity and lending. Banks will also probably try and keep lending off their balance sheets, either by helping companies to issue bonds, or through securitisations. The capital surcharge could therefore impact adversely, not just the return on equity of these banks, but also the supply and pricing of credit in the global economy. In essence, the surcharge penalises banks for diversifying their risk profile and assets geographically and across business lines. There could therefore be an unintended consequence of reducing financial stability. Banks will need to review their long-term strategies and evaluate their product and geographic mixes in order to assess where adequate returns can be made. This creates the likelihood of potential exits from lines of business and/or specific geographic markets, which in turn, could weaken national banking systems as other (non-global) banks may not have the scale, infrastructure, or loss-bearing capacity to fill in market demand for the services. Alternatively, exits may translate into higher pricing for certain services by national providers, or business growth in unregulated segments (shadow banking system). All in all, the G-SIB rule comes to add uncertainty to the planning process and operations of banks at a time when they are dealing with many new rules and a challenging global economic environment.

Liquidity: The Committee points out that G-SIBs enjoy funding privileges, while in the event of failure, the disruption of core activities they perform, e.g. payments, can result in significant 'negative externalities'. This suggests that there should be further emphasis put on the liquidity risk management practices under any policy framework for SIFIs. Both capital and liquidity are lines of defence against financial and economic shocks and, as such, an integrated policy mix would be more appropriate. The dislocation in the markets during the 2008 credit crisis was triggered by a liquidity (funding mismatch) crisis, which eventually resulted in the need for bailouts. Even today, liquidity concerns are at the epicentre of the eurozone sovereign debt crisis rather than immediate solvency concerns as banks have shrunk balance sheets and started to build up their capital in early response to the Basel III framework. The liquidity standard introduced under the Basel III framework generated heavy criticism by the industry; the metrics did not take into consideration banks' differing business models and market positions, effectively imposing a 'one-size-fits-all' standard. Differentiating liquidity requirements for systemically important banks – an approach already adopted by the Swiss regulator for the country's two largest banks – could improve resiliency, particularly in terms of early crisis management and supervisory intervention.

Capital buffers vs. resolution: In dealing with the systemic risks posed by G-SIBs, equal emphasis has been put on both the additional loss absorbency requirement and resolution plans, with implementation of the latter starting in 2012. The Committee has shied away, however, from the proposed Swiss approach of providing a capital rebate on the systemic surcharge if a bank can demonstrate that it has significantly increased resolvability in excess of minimum standards. Perhaps as more jurisdictions adopt the FSB's key attributes of effective resolution regimes, and cross-border agreements are put in place, we can anticipate that resolution becomes the key factor in benchmarking SIFIs (and banks in general), with other indicators becoming less relevant. The Committee agreed to revisit the issue once progress has been made, particularly in the European Union on topics such as a common supervisory system, a common resolution framework and burden-sharing.

Link with Pillar 2: The Committee explicitly prohibits use of the additional loss absorbency requirement to meet Pillar 2 requirements relating to other risks (e.g. interest rate and concentration risks). The potential for the most systemic G-SIBs to have a minimum CET1 ratio of up to 9.5% [4.5%CT1 + 2.5% conservation buffer + 2.5% additional loss absorbency requirement] may render less relevant the Pillar 2 capital buffer planning process. Overall, the indicator-based measurement approach, the pre-specified requirements for banks within each bucket, and the consequences of not meeting the requirements clearly put the policy framework for regulating G-SIBs under the Pillar 1 approach of Basel III.

Level playing field: As with the Basel III framework that the Committee has explicitly stated should be regarded as a minimum standard, the additional loss absorbency requirement represents agreement on a global minimum. The Committee does not rule out the option for host jurisdictions of subsidiaries of G-SIBs to apply the requirement at the individual legal entity level, or consolidated level within the particular jurisdiction. Likewise, it encourages national supervisors to adopt rules for banks identified as systemically important in their respective home market. In fact, a number of jurisdictions such as the US, Switzerland and the UK have either identified their local systemically important banks, or adopted rules specific to these, or both.
As an example, in the US under Dodd-Frank, banks with assets over US$50 billion may become classified as systemically important. The US, Switzerland and the UK introduced domestic rules relating to mandatory recovery and resolution plans for banks prior to the G-20 announcement. As such, a bank's foremost need is to understand how these rules are applied across different jurisdictions, what the timelines for compliance are and to develop strategies accordingly.

Transposition: G-SIBs and systemically important banks at a national level tend to operate in different competitive environments and market infrastructures. For this reason, it is unlikely that the assessment methodology for G-SIBs and measures of systemic importance can be lifted and transposed to identify systemically important banks within a home market. In our view, however, the objective of developing bank resolution regimes – which also allow banks to fail without disrupting significant functions in a domestic market and without the need for public support – should be readily transferrable.

Moral hazard: The roll-out of a formula-driven approach and the clear designation of the banks that constitute G-SIBs (or are systemically important in home markets) could work against the overall goals of reducing moral hazard and incentivising banks to become less important over time. With the loss in ambiguity of which banks are systemically important and a market perception of greater scrutiny applied to these banks from multiple regulators, it is possible that client, counterparty and investor confidence in these banks could grow, which in turn, could help them maintain or gain a funding advantage.

Systemic bias: The downsizing and shedding of certain activities by G-SIBs could potentially mean the fragmentation of activities and their transfer to smaller participants. However, this does not automatically generate better diversification and system resilience. On the contrary, smaller and in some cases, banks ill-equipped to manage complex businesses and the related risks, could result in collateral damage. Problems at many smaller-sized banks with similar risk profiles can render them 'systemic in a herd' and can result in a systemic crisis all the same. The savings and loan crisis in the US market during the 1980s–1990s is an example of this.

The measures at a glance

1. Identifying G-SIFIs[1] and measuring systemic importance

The BCBS has developed an indicator-based measurement approach to identify and measure the systemic importance of banks on the basis of a global, system-wide, loss-given-default (LGD) concept.

There are five selected indicators, namely:

- Bank size.
- Interconnectedness.
- Availability of substitutes for services the banks provide.
- Global (cross-border) activity.
- Complexity.

The indicators do not measure precisely specific attributes of G-SIBs but rather are proxies designed to identify the main aspects of G-SIB status. In other words, they are approximate measures to capture the potential impact of a G-SIB's distress or failure on the broader financial system. The use of indicators that are more risk-sensitive, e.g. indicating the likelihood of failure of a bank, was not considered by the Committee as this approach is embodied in the Basel III framework.

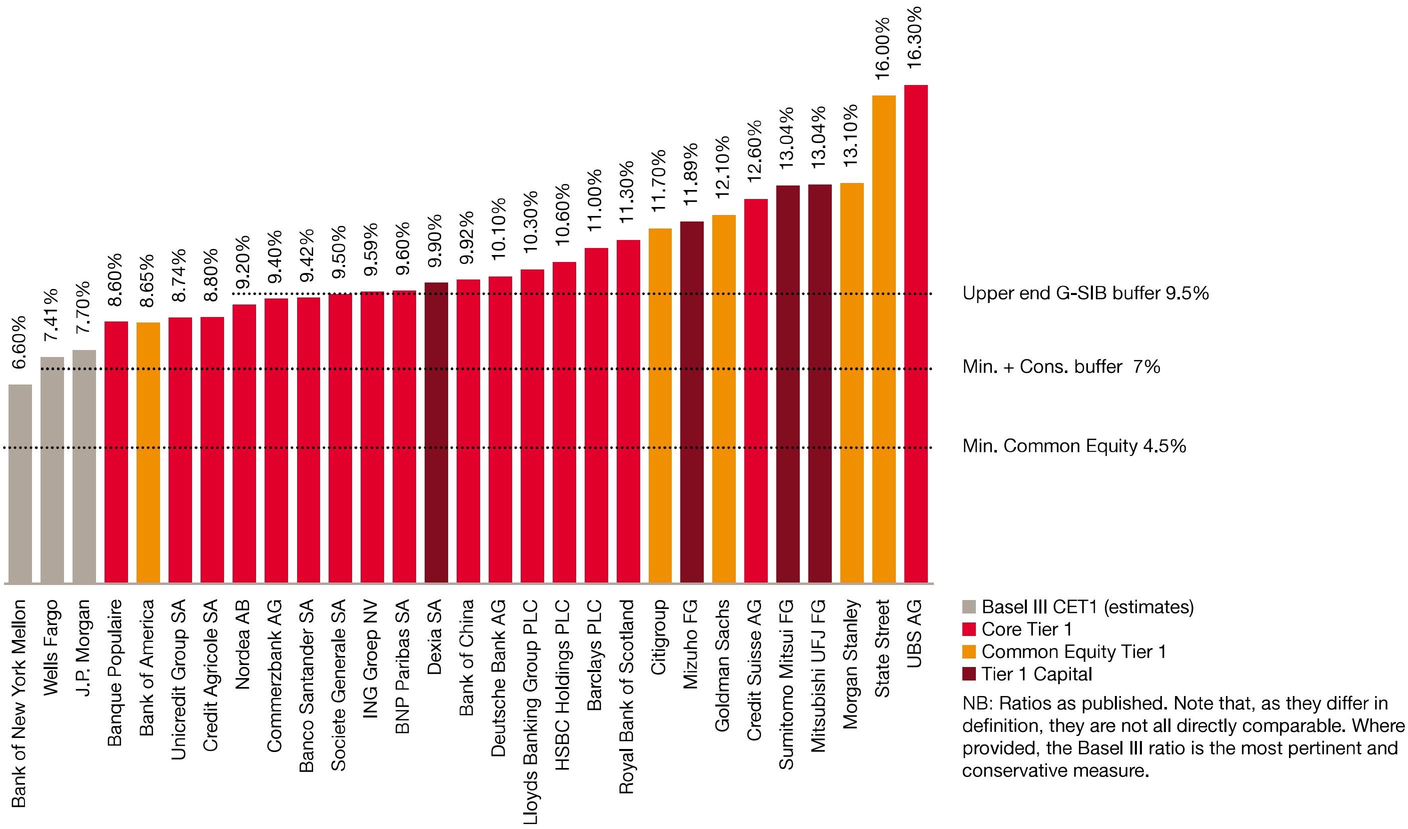
The methodology gives an equal weight of 20% to each of the five indicators, which in turn consist of a range of sub-indicators. Based on a total of scores, the banks are grouped into different categories of systemic importance, with four equal-sized buckets between the cut-off score and the maximum score attained. Each bucket represents a different level of additional loss absorbency requirement. A capital surcharge of 1% of risk-weighted assets is applicable to banks in the lowest bucket (Bucket 1) with the requirement rising to 1.5%, 2% and 2.5% in Buckets 2, 3 and 4, respectively. A fifth bucket with a 3.5% requirement exists, but this is empty to provide a disincentive for the banks to become more systematically important. If the empty bucket becomes populated over time, a new empty bucket with a higher loss absorbency level will be applied.

The following are key conditions and results of the BCBS's assessment methodology:

- **A sample of 73 global banks** for which end-2009 data was collected for the purposes of developing the methodology is to be reviewed every three years.
- If the rules applied to the sample of the banks **at the present time, 29 global banks** would be faced with the additional capital charges of 1% to 2.5% of their risk-weighted assets. The Committee identified 27 banks, with two banks added, based on supervisory judgement applied by the home supervisors. A tentative cut-off point was set between the twenty-seventh and twenty-eighth bank, based on the clustering of scores produced by the methodology.
- The additional loss absorbency requirement is to be met by **CET1 only,** as defined by the Basel III framework.

1 Referred to as G-SIBs in the BCBS July 2011 consultation document, they are in fact a specific subgroup of SIFIs.

Figure 1: The 29 G-SIBs – Who they currently are



NB: Ratios as published. Note that, as they differ in definition, they are not all directly comparable. Where provided, the Basel III ratio is the most pertinent and conservative measure.

Source: Published quarterly results and interim management statements as of 30 September 2011

- **The list of G-SIBs will not be fixed.** The Committee plans to update on an annual basis the banks' indicator scores and bucket positions. Banks can therefore migrate in and out of G-SIB status over time, and between categories of relative systemic importance.
- The additional loss absorbency requirements **will apply from 2016**, initially to those banks identified in November 2014 as G-SIBs on the basis of end-2013 data. The requirement will be **phased-in** in parallel with the capital conservation and countercyclical buffers becoming **fully effective on 1 January 2019**.
- National jurisdictions are to implement official regulations/legislations by 1 January 2014. The additional loss absorbency requirement set out by the BCBS **is the minimum level**. National jurisdictions are free to impose higher loss absorbency requirement to domestic systemically important banks, if they wish to.
- If a G-SIB progresses to a bucket requiring a higher loss absorbency requirement, it must meet this within a timeframe of **12 months**. Given the short timeframe in which banks have to comply, it appears that as a first mitigant action, a bank would seek to reduce its business activity before raising new additional capital.
- If a G-SIB breaches the additional loss absorbency requirement, it must agree a capital remediation plan over a timeframe to be established by the supervisor. Until the plan is completed and the bank is compliant, it will be subject to **limitations on all discretionary disbursements defined by the conservation buffer bands**, and any other arrangements required by the supervisor.
- **The Committee will disclose** the denominators used to normalise the indicator scores, the cut-off score for a bank to be a G-SIB as well as the threshold scores for the five buckets **by November 2014,** based on end-2013 data. The Committee expects all banks identified as G-SIBs to publicly disclose the relevant data when the G-SIB policy is implemented. By combining the information disclosed by BCBS and the G-SIBs, **market participants will be able to replicate the methodology.**

In finalising the rules text in November 2011, the Committee also provided additional guidance to address market criticism on the lack of transparency over the method for choosing the sample, as well as concerns with how to ensure that an individual bank's reduction in systemic impact is recognised if the scores for banks in the reference system change in either direction:

- The sample of 73 banks was agreed, based on the size and supervisory judgement and accounts for broadly 65% of global bank assets.
- The Committee will conduct a review of the assessment methodology every three years. The broad objective of the review will be to adjust the measurement framework for changes that are not related to the overall systemic importance of the banking industry at the global level (e.g. GDP growth, major exchange movements). The Committee does not plan to conduct a fundamental review of the methodology every three years, i.e. bucketing approach (4 buckets + 1 empty) and the increments of the additional loss absorbency (0.5%).
- Under the assessment methodology, each indicator is normalised by the sample total, which means that a firm's score is its proportion of the sample total, i.e. it is initially a relative score. The Committee agreed to fix the denominators until the next periodic review of the methodology, meaning that the scores will effectively be absolute measures that recognise an individual bank's reduction in systemic impact.

Going forward, the Committee will flesh out a more transparent methodology to set the sample as well as the principles of the periodic review, including objectives and possible tools.

The economic impact of the additional loss absorbency requirement

The Macroeconomic Assessment Group (MAG), which assessed the macroeconomic impact of the Basel III rules, also undertook an impact study of the G-SIB recommendations and published its results in October 2011. For the purposes of the study, the MAG collected information on the importance of the G-SIBs in lending and total assets for each national financial system. Applying the Basel Committee's current methodology, the MAG identified the following:

- The share of lending to the non-financial private sector by the top 30 G-SIBs in the 15 economies represented on the MAG ranges from about 4% to about 75%.
- The share of total banking-system assets ranges from 9% to 77%.
- The unweighted mean of these G-SIBs' shares is 31% in the case of non-financial private lending and 38% for assets.
- The GDP-weighted means are 40% for non-financial private lending and 52% for assets.

Combining this information with that from the 2010 Basel III impact study, the MAG calculated provisional estimates of the impact of additional loss absorbency on G-SIBs as follows:

- A one percentage point increase in capital applied to G-SIBs would dampen growth by an additional 0.7 basis points per year for an eight-year implementation period.
- For a four-year implementation period, the impact is 1.1 basis point per year on average.

In both cases, economic growth is forecast to accelerate above its trend level for several quarters after the point of peak impact is reached, as it recovers towards its baseline. Drawing also on the findings of the Committee's long-term assessment of economic costs and benefits (the LEI report), the MAG estimates that in the long run the G-SIB framework could provide an annual benefit of 40–50 basis points of GDP, reflecting the reduced probability of a systemic financial crisis. However, the MAG report discusses other factors that could have an impact on these results.

Regulators and the industry remain divided over the economic impact and costs associated with increasing capital and liquidity requirements. Table 2 below presents the results over a number of such studies. The differing outcomes are a result of different assumptions and methodologies.

Table 2: A comparison across Basel III impact studies

	Impact on capital ($ trillion)	Impact on lending rate (bps)	Impact on credit volume (%)	Impact on GDP level (%)	Impact on GDP growth (% point)
BIS (a)	--	15	-1.4%	-0.19%	-0.04%
OECD (b)	--	50	--	--	-0.79%
IMF (c)	--	71	-5.8%	--	--
EC (d)	--	66	--	-0.83%	--
IIF (e)	1.3	376	-4.8%	-3.1%	-0.6%

Source: 'The Cumulative Impact on the global economy of changes in the financial regulatory environment', IIF (Sept. 2011)

(a) Basis points increase in lending spreads from baseline and percentage deviation of lending volumes and GDP from baseline, evaluated after 18 quarters on a 4-year transition period to the new regulatory standards; year-on-year average growth rate loss during the first 18 quarters of implementation

(b) Estimate for 2015 (2019 for lending rate)

(c) 'Long run' estimate

(d) Estimate after eight years

(e) 2015 estimates for capital and real GDP level; 2011–15 average for all other variables. Includes also country-specific regulatory changes

It has to be recognised that despite the use of various models, empirical research in this area is still in its early days. However, US officials have been forthright in acknowledging that the aggregate impact on credit from financial services reform, including the Dodd-Frank Act and Basel III, has not been analysed due to the associated analytical constraints. The Federal Reserve Chairman Bernanke has said: "It's just too complicated. We don't really have the quantitative tools to do that."[2]

2 Question and Answer session following Chairman Bernanke's speech on the US economic outlook on June 7, 2011

2. Common data template for G-SIFIs

Although banks are already faced with increased scrutiny and disclosures under the Basel III framework, there will be a need for further disclosure and aggregation of statistics to calculate the five indicators under the BCBS's assessment methodology. As acknowledged by the Committee, data for many of the G-SIB indicators do not currently exist.

As a step towards meeting these requirements, on 6 October 2011, the FSB published the document 'Understanding Financial Linkages: A Common Data Template for G-SIBs' with the consultation process ending on 8 November 2011.

The proposed common data template is designed to gather information around four broad areas:

Institution-to-institution (I-I)	Institution-to-aggregate(I-A)	Structural and systemic importance	Passive and ad hoc data
Bilateral credit exposures and funding dependencies to assess network risks and resilience	Credit exposures and funding dependencies to countries, sectors and markets to understand risk concentrations and vulnerabilities	Information to facilitate the assessment of systemic importance and support crisis management	Predefined data 'on request' and 'ad-hoc' requests to meet increased information needs to assess emerging systemic risk

Implementation of the proposed data collection is expected to be in three phases:

- Phase 1 (I-I) by end-2012.
- Phase 2 (I-A) by end 2013.
- Full template disclosures to be reached by end-2014.

It is not surprising that the implementation for full disclosures coincides with the horizon for the determination process of G-SIBs, after which the banks will have to comply with the additional loss absorbency requirements, starting 1 January 2016.

Banks have a strong incentive to build the capacity to gather, analyse and report the data across divisions and legal entities. Errors and/or omissions may distort their perceived systemic importance, which may be punitive. It may not end there. Large internationally active banks other than G-SIBs may be asked to provide information according to the proposed template in an effort to improve the understanding of key linkages within the global financial system. Likewise, national or regional authorities are also being encouraged to consider collecting similar data for banks that they judge to be systemically important, domestically.

As the market should be able to replicate the calculations for G-SIBs based on information released by the Committee and G-SIBs, this suggests that data defined under the common template could find their way into the public domain. The heightened degree of disclosure is bound to change market standards and discipline around transparency.

3. Effective resolution of SIFIs

The FSB policy package aims to improve the capacity of authorities to resolve failing SIFIs without systemic disruption and without exposing the taxpayer to risk of loss. To achieve this, it focuses on the following measures:

- **Strengthened national resolution regimes –** The designated resolution authority is given a broad range of powers and tools, including statutory bail-in, to resolve financial institutions that are not viable.
- **Cross-border cooperation arrangements –** Institution-specific cooperation agreements supported by national law that enable resolution authorities to act collectively to resolve cross-border firms in a more orderly and less costly way.
- **Resolution planning by firms and authorities –** *Ex ante* resolvability assessments that should inform the preparation of Recovery and Resolution Plans (RRPs) and making RRPs mandatory for global SIFIs.
- **Removal of obstacles to resolution –** Actions to remove obstacles arising from complex firm structures and business practices.

The market has generally been sceptical as to how much progress can be made in harmonising the relevant aspects of legal frameworks across jurisdictions to wind down a SIFI's activities in an orderly manner. During the consultation process, the banking industry advocated a binding international agreement and a mutual recognition framework. However, the FSB does not consider that more binding mechanisms will be feasible without first putting in place convergent regimes and incentives to cooperation that, when implemented, the Key Attributes will deliver.

It may be difficult to move forward as planned. Local authorities have considerable work to do in a number of legal and regulatory areas before they can improve their national regimes and move to convergence. In parallel to changing or introducing new insolvency laws, national authorities will need to address issues such as:

- **Resolution funds –** Jurisdictions should have in place privately financed deposit insurance or a funding mechanism for *ex post* recovery from the industry of the costs of providing temporary financing to facilitate resolution. In EU Member States, such funds financed by levies are being proposed under the 'EU Framework for Crisis Management in the Financial Sector'.
- **Resolution measures –** A bail-in mechanism needs to be complemented with a set of other restructuring actions such as replacement of management and measures (e.g. asset transfers, termination of contracts, bridge banks, etc.).
- **Bridge banks –** Need to develop a framework that addresses who provides the necessary capital and liquidity to the bridge entity, how the infrastructure of the failed bank is used by the bridge entity and the exit strategy for the bridge entity itself.
- **Property rights of stakeholders –** The need to properly balance the rights of shareholders and creditors with the general interest in the financial system's stability. The FDIC's role and powers in the US are potentially viewed as the standard-setter in developing such mechanisms.

Another potential impediment to speedy convergence and also to swift and effective resolution as and when a SIFI fails, is the plethora of Crisis Management Groups. From a European perspective, there are 14 global CMGs for which EU authorities act as coordinators. On the basis of ECB data, there are an estimated 40 banking groups when it comes to EU headquartered banks with significant cross-border activity. Over 40% of these have presence in at least ten Member States, meaning each State and its resolution authorities/funds would potentially get involved, should one of these groups fail.

As experience has shown with the European sovereign debt crisis, there is a need for a central crisis mechanism. The euro area could therefore benefit from a European Resolution Authority versus what would be a long-termed effort to harmonise multiple regimes.

Milestones

December 2011

First drafts of recovery plans of G-SIBs should be completed.

June 2012

Modalities for information sharing within the Crisis Management Groups (CMGs) and the first drafts of cross-border cooperation agreements should be completed.

First drafts of the resolution plans of the G-SIBs should be completed.

Home authorities of G-SIBs should have entered discussions with firms and members of the respective CMGs as regards the preliminary assessment of the firms' resolvability.

December 2012

Home authorities of G-SIBs should have entered into cooperation agreements with the key host authorities.

Recovery and Resolution Plans of G-SIBs to be completed. First resolvability assessment should be completed.

Modalities for cooperation and information sharing between the home authorities and host authorities of jurisdictions not represented in the CMG where the G-SIBs have a systemically important presence, should be established.

What comes next?

What comes next in systemic risk supervision?

The FSB and the BCBS have already initiated work to define the approach to extend the G-SIB framework to all SIFIs. To this effect, the International Association of Insurance Supervisors (IAIS) is expected to complete its assessment methodology for identifying global systemically important insurers in time for the G-20 Summit in June 2012. The IAIS will also develop a Common Framework for the Supervision of Internationally Active Insurance Groups by 2013 in order to foster group-wide supervision and global convergence of regulatory and supervisory approaches.

In early 2012, the international standards for core financial market infrastructures are also expected to be finalised. Implementation of OTC derivatives' reforms, together with oversight and regulation of the 'shadow banking' system are key commitments to the G-20. The FSB has outlined five areas for taking regulatory action in order to further contain systemic risk:

- The interaction of banks with the shadow banking sector.
- Reducing the susceptibility of money market funds to runs.
- The regulation of the shadow banking sector on prudential grounds.
- Retention requirements and transparency in securitisation.
- Regulation of margins and haircuts in securities' lending and repos.

Of all the new policy measures, the one with the most immediate impact is likely to be the FSB's initiative to increase the intensity and effectiveness of supervision, holding national supervisors to higher standards. The first changes will come through the revamping of the Basel Core Principles on Effective Supervision, the global standard against which supervisors are assessed as part of the IMF/World Bank Financial Sector Assessment Program. The changes will address issues such as the availability of resources, level of expertise and the independence of supervisors. The FSB will prepare by end-2012, a report on issues that hamper supervisors with respect to oversight of G-SIBs, and will cover factors such as information systems and data, use of internal models, risk appetite frameworks and business models at these banks. The FSB will also conduct a review on risk governance at the banks with a focus on the risk committee of executive boards and the risk management functions. In parallel, the Committee will review standards under its 2008 report on 'External Audit Quality and Banking Supervision' to reinforce supervisory confidence in audit quality, a critical element to effective supervision.

Conclusion

The new framework to address the systemic risks posed by G-SIBs is one of a number of significant regulatory changes that will have far-reaching consequences. It remains unclear whether the regulatory burden will be limited to G-SIBs. We believe the effect could be felt across the-board: by customers, through higher loan pricing and fees; by banks, through balance-sheet restructuring and cost reduction; by shareholders and investors through the erosion of dividend contributions and from changes in asset and investment allocation decisions; and by the wider economy, through a reduction in the availability of credit.

The far-reaching and profound impact of these rules and a relatively short implementation timetable means that there is no time to lose. All banks, the systemically important and others, need to consider the new rules and assess the strategic and operational implications.

How can we help?

PwC has the expertise to help you address complexities like these successfully and create real value from Basel III. We are currently working with our clients to address the many regulatory changes that are affecting them, to understand interdependencies and overlaps, and to create real value in today's complex and changing environment.

Additional information

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Recovery & Resolution Plans | FSA Consultation (August 2011)

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