

**Presentation to  
Regulatory Policy Institute  
Merton College Oxford**

**14 September 2010**

# Crisis

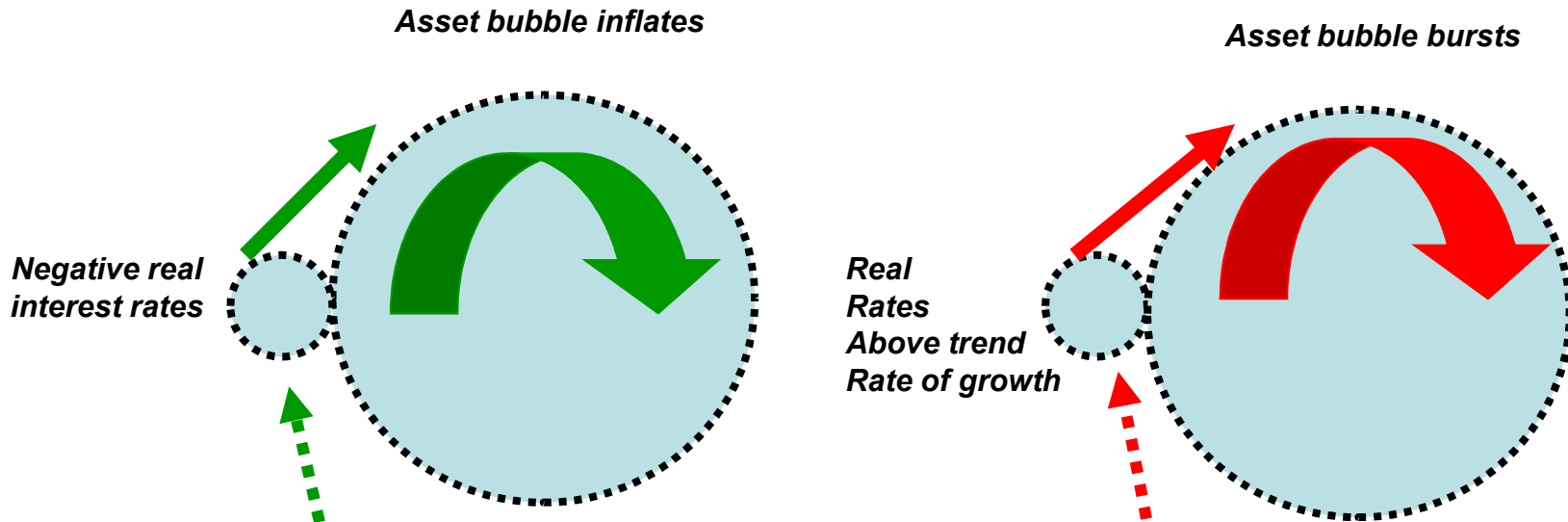
Cause,  
Containment  
and Cure



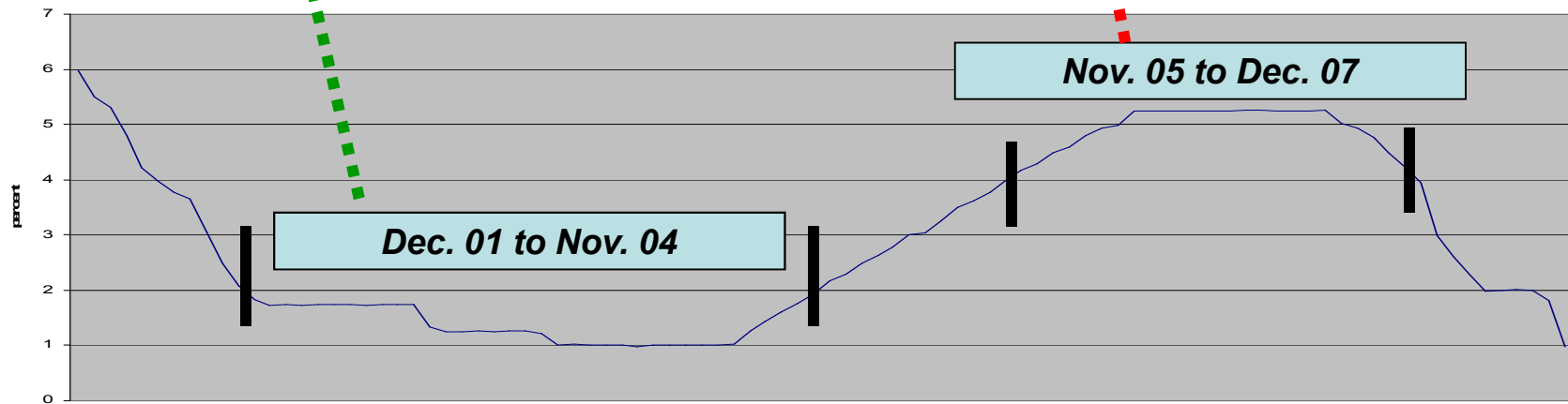
Thomas F. Huertas



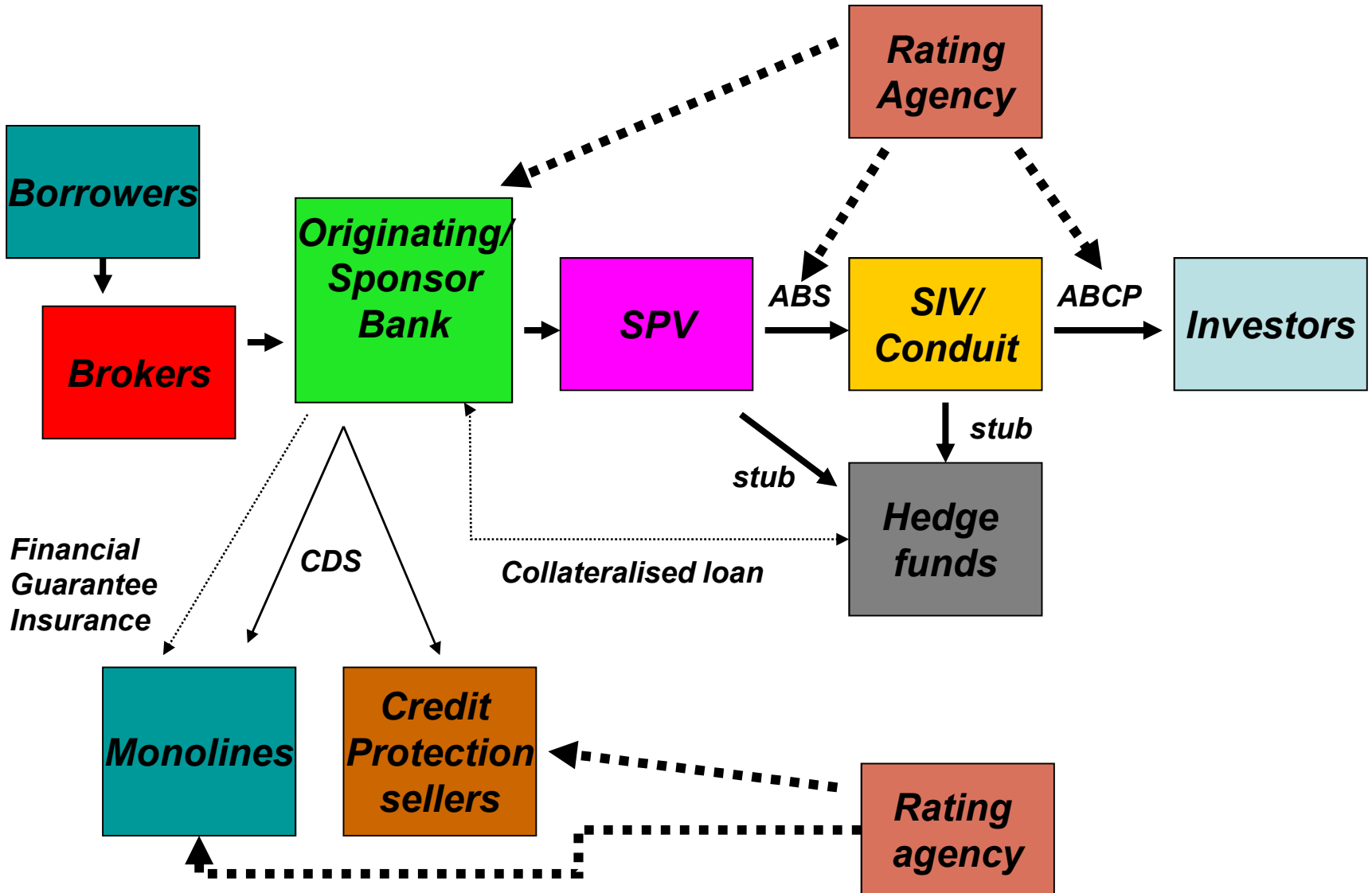
# Cause 1: Monetary policy



Fed funds rate 2001 - 2008

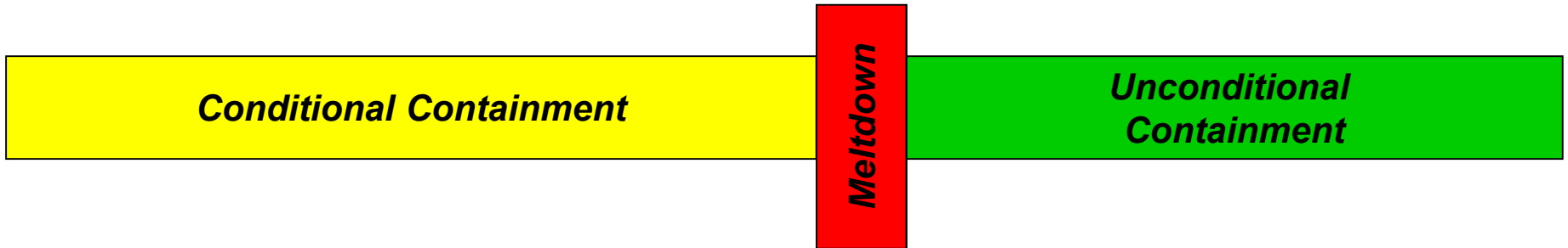
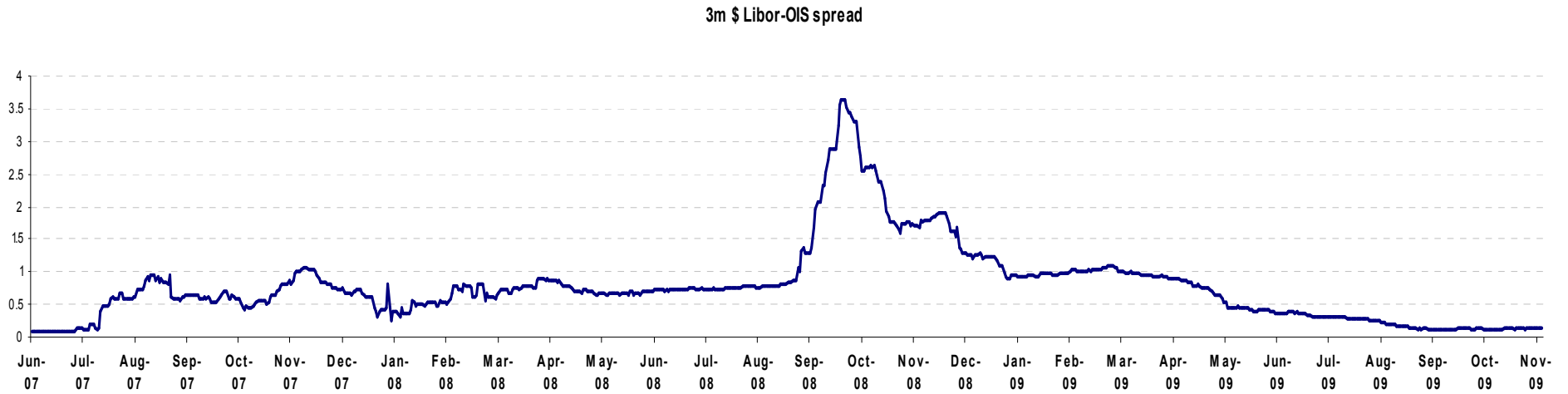


## Cause 2: Shadow Banking



# Cause 3: Shift in US resolution policy

3 month USD LIBOR-OIS spread in percent,  
June 2007 – November 2009

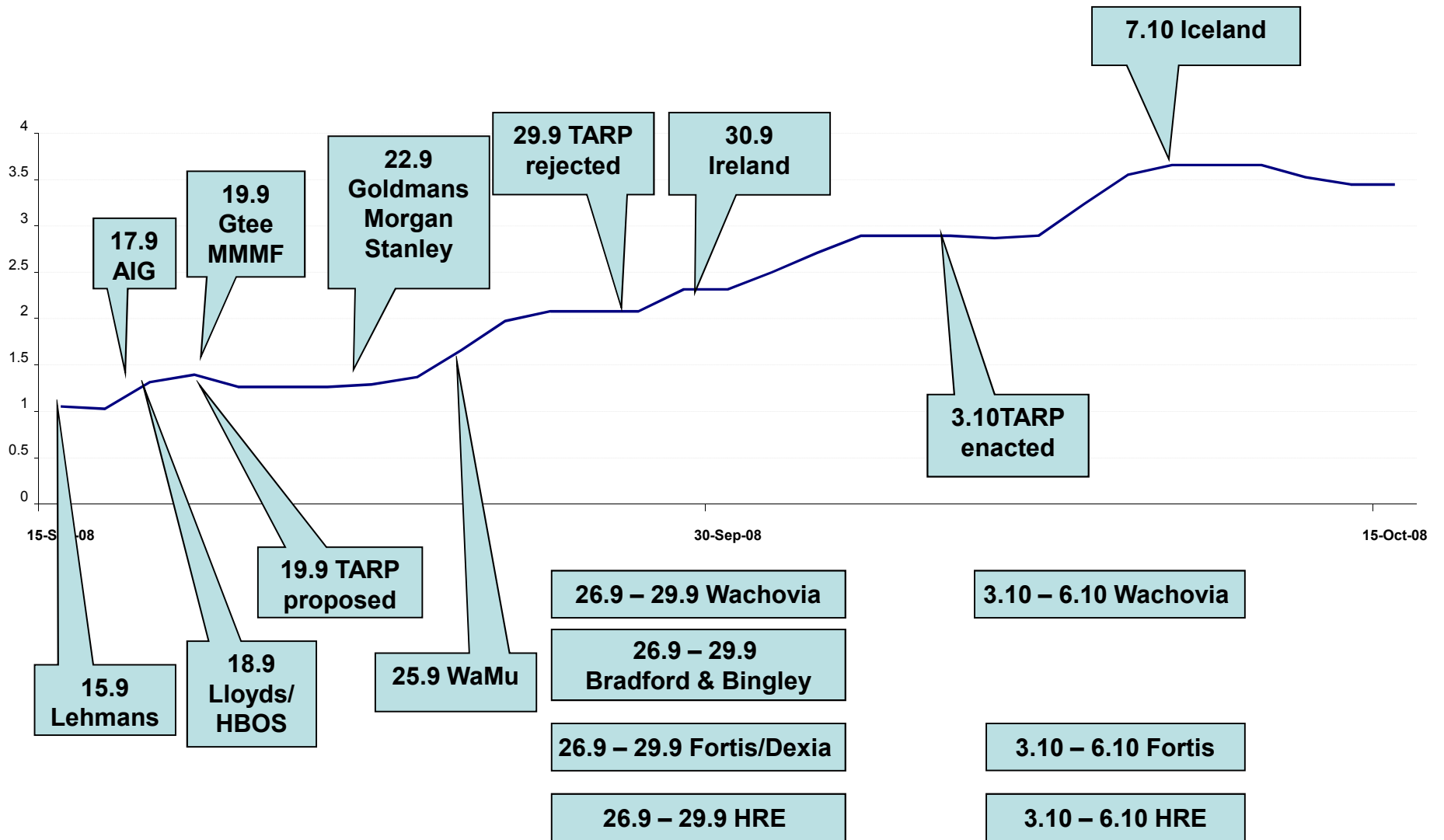


## Probability of bail out determines risk

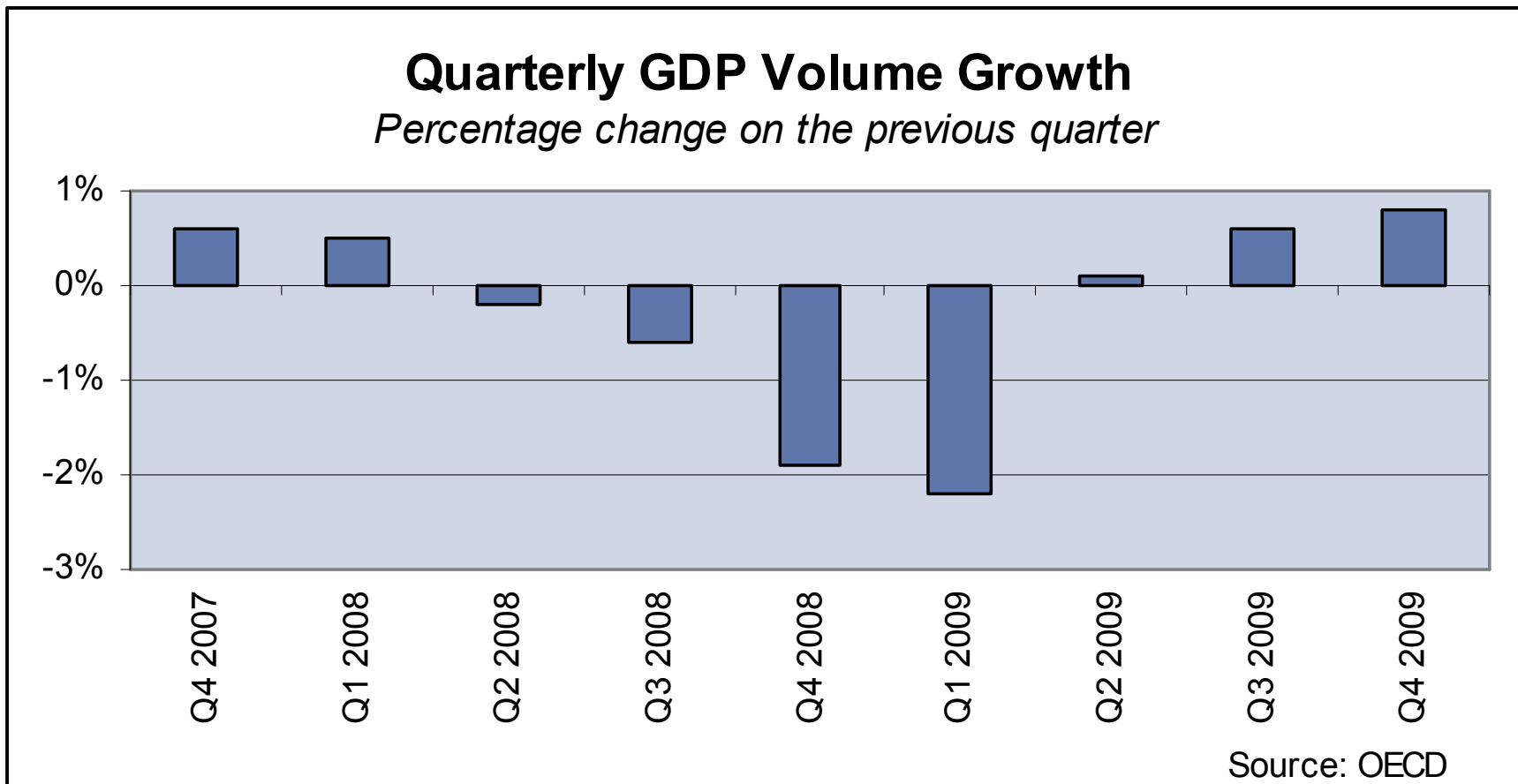
	Likely to be rescued	Likely to be abandoned
<b>Probability of default</b>	<b>20%</b>	<b>20%</b>
<b>Loss given default</b>	<b>25%</b>	<b>25%</b>
<b>Loss given bail out</b>	<b>0%</b>	<b>0%</b>
<b>Probability of bail out</b>	<b>95%</b>	<b>5%</b>
<b>Expected loss</b>	<b>25 bp</b>	<b>475 bp</b>

# Moving toward Meltdown

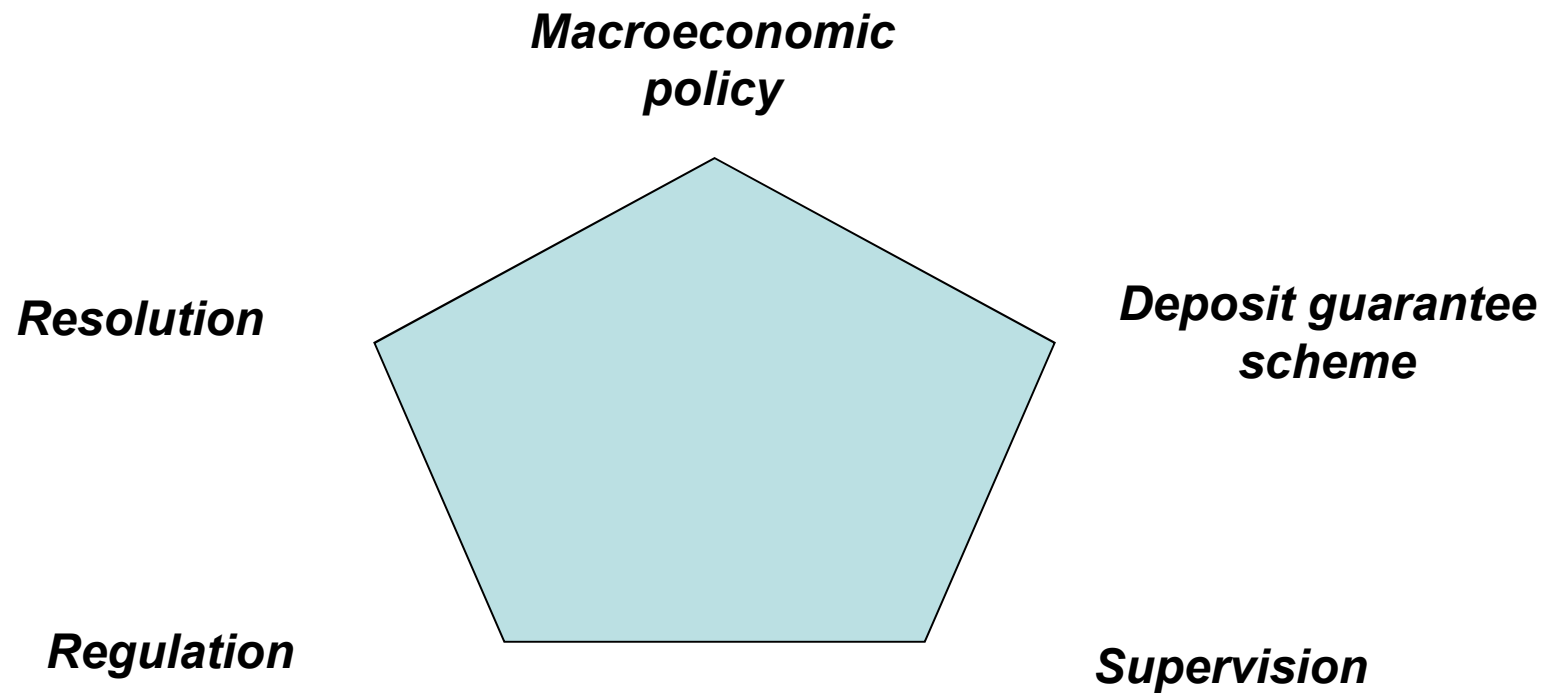
3 month \$ LIBOR – OIS spread in percent  
15 September 2008 to 15 October 2008



# The world economy goes into free fall



**A cure for crises  
requires a comprehensive and consistent framework**





# Regulation

- ✓ **Capital**
  - ✓ **Correct trading book regime**
  - ✓ **Improve quality of capital**
  - ✓ **Increase quantity of capital**
  - ✓ **Introduce leverage ratio as back-up**
- ✓ **Liquidity**
  - ✓ **Introduce global liquidity standard**
- ✓ **Remuneration**
  - ✓ **Introduce regulation to assure that remuneration promotes effective risk management**

# Supervision

- ✓ **Change approach**
  - ✓ **Pro-active**
  - ✓ **Forward looking**
    - ✓ **Stress testing**
    - ✓ **Recovery plans**
  - ✓ **Intrusive**
- ? **Change organisation**
  - ? **In UK**
  - ? **In EU**
  - ? **In US**

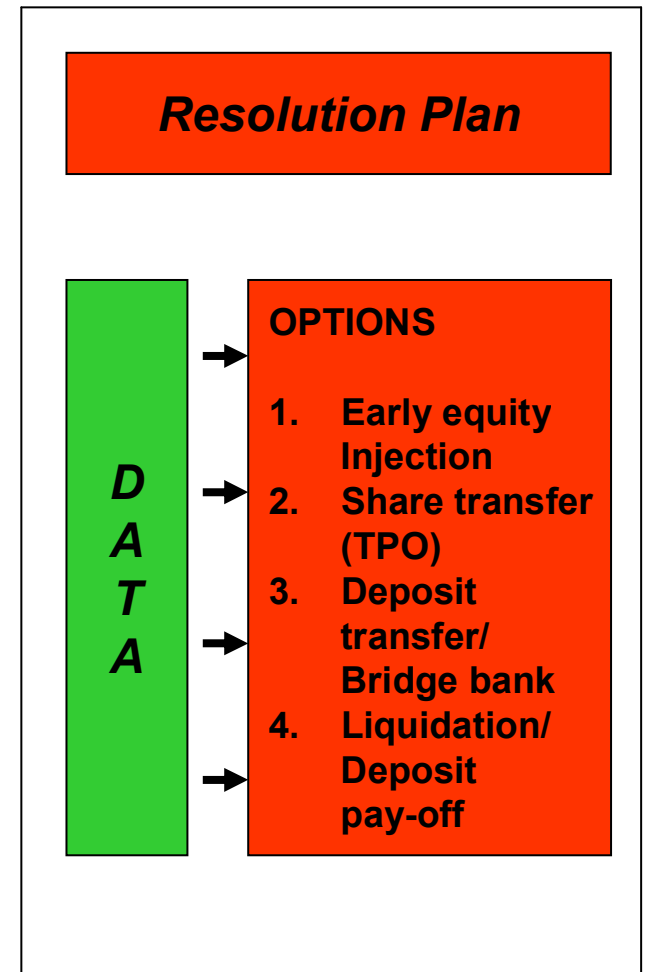
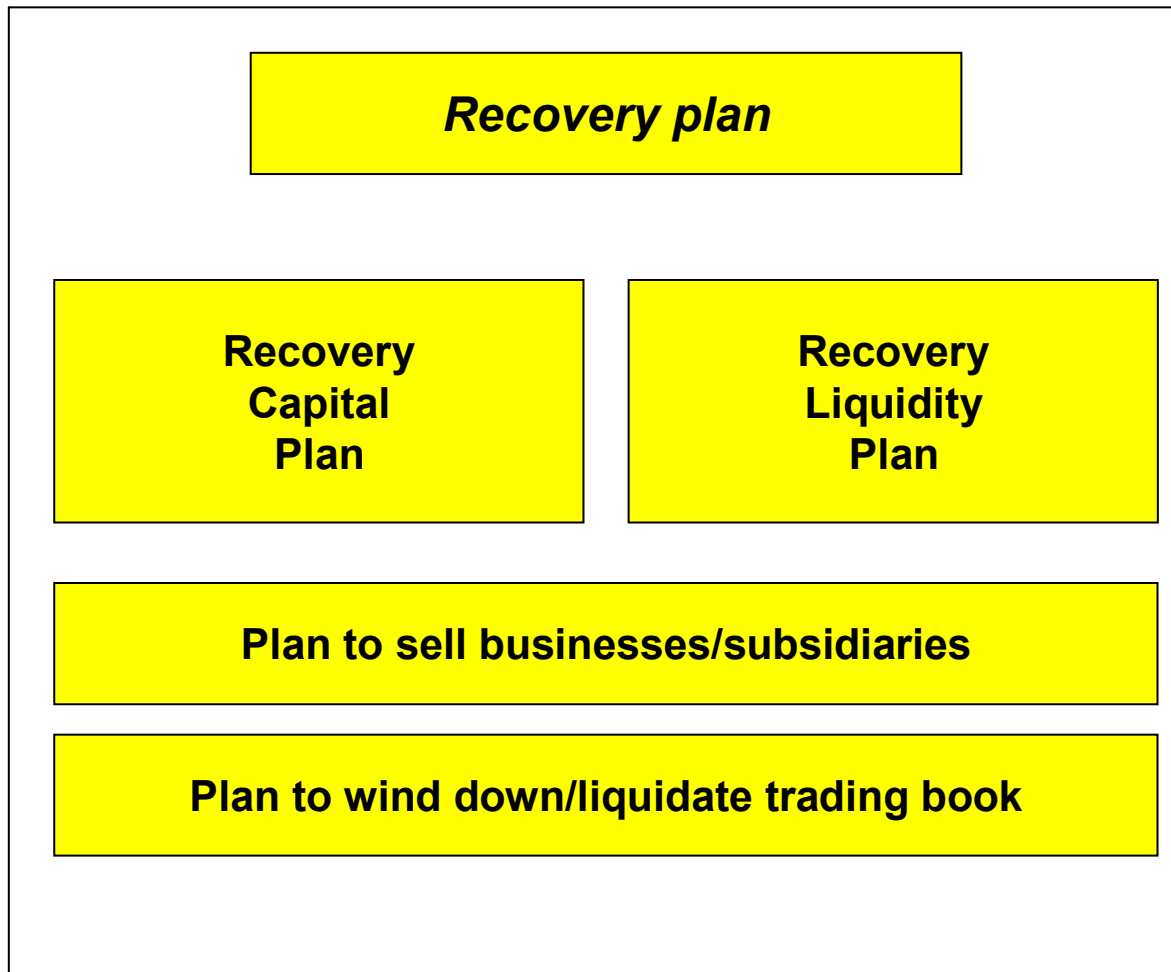
# Deposit guarantee schemes

- ✓ **Co-insurance eliminated**
- ✓ **Limits raised**
- ? **Operations improved to enable prompt pay out**
  - ✓ **In US**
  - ✓ **In UK**
  - ? **In EU**
- ? **Funding**
  - ? **Backstop from government**
  - ? **Pre-funded**
    - ? **If so, risk-based?**

# Resolution

- ✓ **Special resolution regimes for banks**
  - ✓ In US
  - ✓ In UK
  - ? In EU
- ✓ **Recovery and resolution plans**
- ? **Resolution funds**
- ? **Bank taxes**
- ? **Restructuring**
  - ? **Make banks smaller**
  - ? **Make banks simpler**

## Recovery and resolution plans ('living wills')

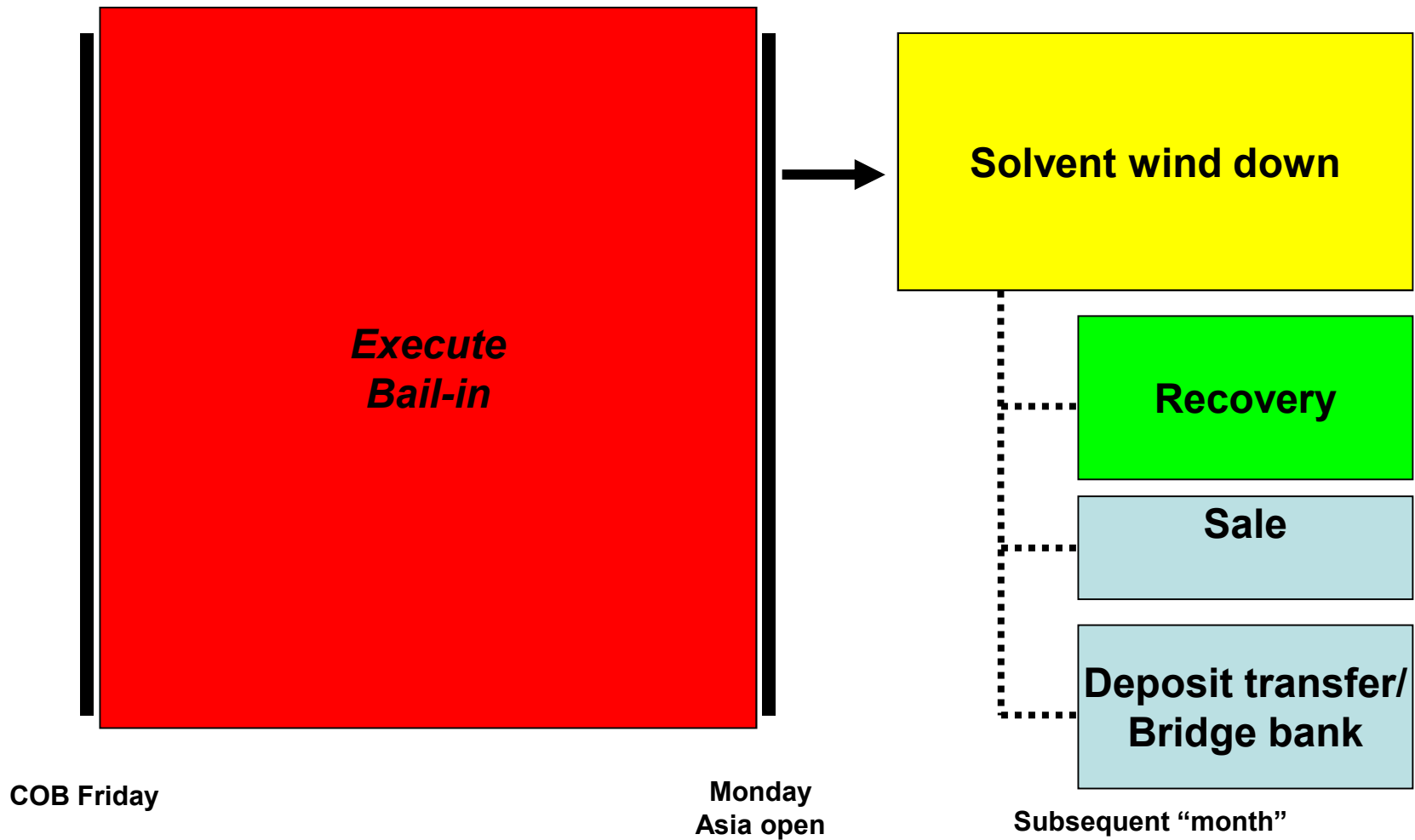


# Overview of Resolution Methods

	<b>Taxpayer support</b>	<b>Immediate impact/cost</b>	<b>Long-term impact/cost (moral hazard)</b>	<b>Going/gone concern</b>
<b>Options under SRR</b>				
<b>1. Liquidation/ deposit payoff</b>	<b>None</b>	<b>Very high</b>	<b>Eliminates moral hazard</b>	<b>Gone</b>
<b>2. Deposit transfer/ bridge bank</b>	<b>Limited</b>	<b>High</b>	<b>Improves market discipline and reduces cost</b>	<b>Gone</b>
<b>3. Share transfer/TPO</b>	<b>TBD</b>	<b>TBD</b>	<b>TBD</b>	<b>Going</b>
<b>Option outside SRR</b>				
<b>Early equity injection</b>	<b>Very high</b>	<b>Limited</b>	<b>High (increases moral hazard)</b>	<b>Going</b>

# From bail-out to bail-in

intervention



# Macro-policy

- ✓ **Introduce macro-prudential policy**
  - ✓ **Create counter-cyclical buffer in banks**
  - ? **Develop other macro-prudential tools**
    - ? **Limits on loan to value ratios**
    - ? **Direct transactions to central counterparties**
    - ? **Others?**
- ✓ **Introduce systemic risk boards**
  - ✓ **In US**
  - ✓ **In UK**
  - ✓ **In EU**
- ? **Have systemic risk boards identify and mitigate systemic risks in a timely fashion, including those risks that emanate from policymakers themselves**