What Are the Repercussions of Allowing a Systemically Important Institution to Fail?

- A failure of systemically important institutions could threaten the stability of the financial system and the health of the broader economy
- Doubts about a large institution’s solvency could trigger runs on other big banks
- The financial system is highly interconnected and if one bank fails, other banks with claims on the failed bank could be left insolvent
- The size and interconnectedness of these institutions make it difficult to be certain about the impact of a collapse, but failures undoubtedly would have exacerbated the following dynamics:
  - Reduced liquidity leading to further credit contraction
  - Increased borrowing costs
  - Continued asset price declines
  - Increased uncertainty about the value of complex financial assets
  - Further deterioration of market confidence

Although difficult to quantify, the systemic risk of allowing these institutions to fail was perceived to be too high by the government.
Impact of the Lehman Brothers Failure

- Lehman Brothers was not considered too big to fail, but its bankruptcy had a significant impact on the economy and shook market confidence
  - Global stock markets lost trillions in value in the following weeks
  - Credit spreads widened dramatically
  - Liquidity disappeared as banks stopped lending to each other and overnight LIBOR more than doubled
  - Capital markets stopped functioning properly and new issuance activity came to a standstill
  - The CDS market was disrupted by defaults with hundreds of counterparties
  - Money market funds with Lehman exposure suffered losses, causing one firm to break the buck and roiling the commercial paper market
  - A flight to quality ensued, driving yields on short-term treasuries to 0% and further reducing prices of mortgage-related assets

Lehman’s bankruptcy demonstrated the interconnectedness of the financial system
Negative Impact from a “Too Big To Fail” Policy

- Creates moral hazard
- Distorts competition through greater capital availability and lower funding costs for institutions perceived to be too big to fail
- Incents unchecked growth to attain “too big to fail” status
- Saves companies with potentially broken business models
- Requires significant taxpayer resources

Too big to fail protection is costly
Prevention Measures

Maintain a Level of Uncertainty Surrounding Government Intervention

- Debt investors will penalize institutions that take on excessive risk with higher interest rates
- Maintain the deposit cap to limit the upper level of “too big”

Enhance Capital Requirements & Accountability

- Enhance capital requirements to include internal risk modeling measurement and control from within the institution as well as from the regulators
- Regulate leverage strategies and techniques
- Ensure compensation structures are properly aligned
- Increase management and director accountability by replacing them upon failure
Prevention Measures

Improve Regulatory Oversight

- Consolidate regulatory entities into fewer, more efficient entities with a centralized and accountable system of oversight
- Integrate regulation of credit, interest rate, market and liquidity risks into a comprehensive risk management process within large firms
- Create a regulatory review and approval process for new financial instruments

Create an Oversight Regulator With Jurisdiction to Manage Systemic Risk

- Focus regulatory oversight on a limited number of large market participants, both banks and non-bank institutions that have interdependencies with banks
- Allow for seizure of a non-bank institution prior to insolvency
- Ensure capital requirements are large enough to cover systemic risk, regardless of whether the institution is regulated
- Assess fees for systemic risk
  - Increase FDIC deposit premiums commensurate with higher levels of risk since these institutions require a higher implicit FDIC guarantee
Prevention Measures

**Improve Transparency in CDS and Other OTC Markets**

- CDS and other OTC derivatives should be migrated to exchanges to improve transparency and ensure the integrity of contracts
- Require adequate disclosure and transparency to allow the market to sufficiently determine the embedded level of risk

**Resolution Measures**

- Develop specific programs to manage the orderly resolution of any systemically significant financial institution, whether a bank or non-bank entity
- Develop an exit strategy to provide clarity around what remedial action should be taken, when and by whom
- Place rescued firms under the FDIC, eliminate their equity and shrink them back to size where they are not “too big to fail”
A Financial System Validated by the Current Crisis
Canadian Banks have Outperformed their U.S. Peers Since the Beginning of the Credit Crises

In 2008, the World Economic Forum ranked Canada’s banking system the soundest in the world.
Among the Large North American Banks, the Capitalization of Canadian Banks Has Held Up Better than U.S. Peers

Top 5 U.S. and Top 5 Canadian Banks by Market Capitalization

5 Largest U.S. Banks as of 1 Year Ago
Avg. Δ in Market Cap: (46%)

5 Largest Canadian Banks as of 1 Year Ago
Avg. Δ in Market Cap: (20%)

Why Canadian Banks Have Outperformed their U.S. Peers

**Prudent and Disciplined Risk Management Practices**
- Higher capital ratios pre-crisis
- More conservative lending practices
  - Minimal subprime mortgage exposure, no ARMs

**Stringent Regulatory Oversight**
- Higher capital requirements
- Fewer banks to regulate
- Government regulation protects the domestic banks by limiting foreign competition

**More Risk Averse Behavior in Households**
- Mortgage interest not tax deductible so borrowers are incented to pay down mortgage quickly
- Canadian homeowners have been less inclined to drawdown on the equity in their homes

**Diversification**
- Banks are national in scope, making them less susceptible to regional downturns
- Large investment banks all owned by commercial banks and benefit from lower risk balance sheet of the commercial banking unit
- Investment banks subjected to heightened regulatory scrutiny when compared to U.S. investment banks