

Phases of Systemic Risk in the GFC

A CRO perspective

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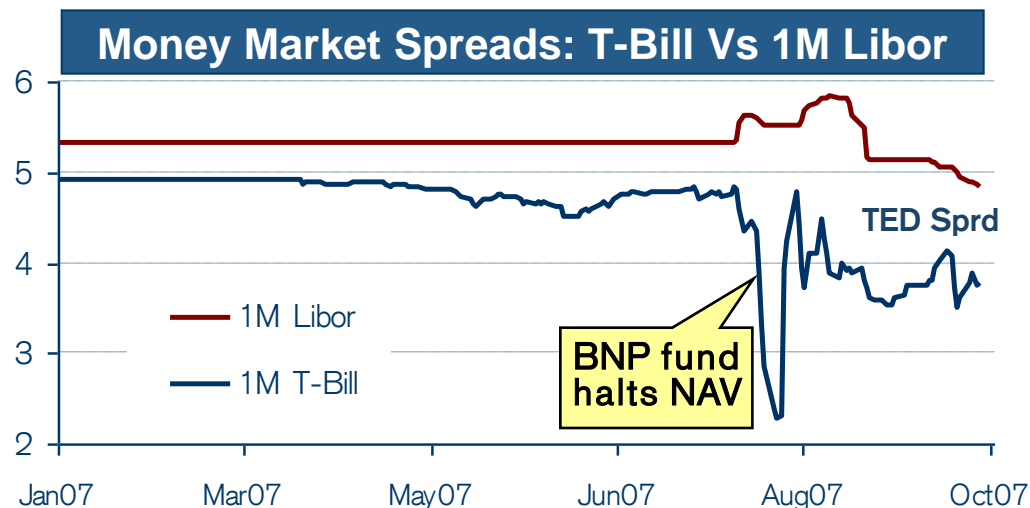
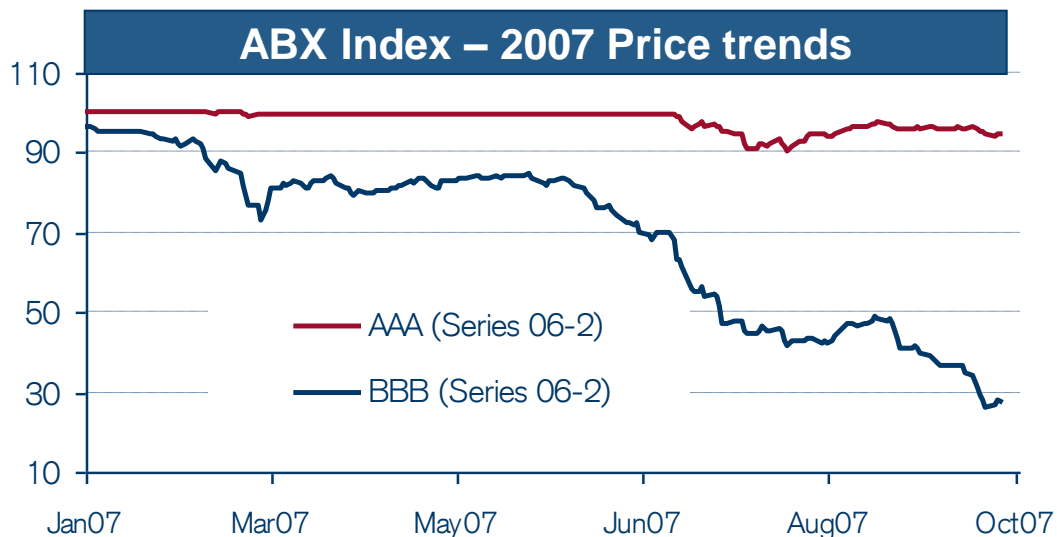
What can we learn from the Great Financial Crisis?



Phases of the GFC

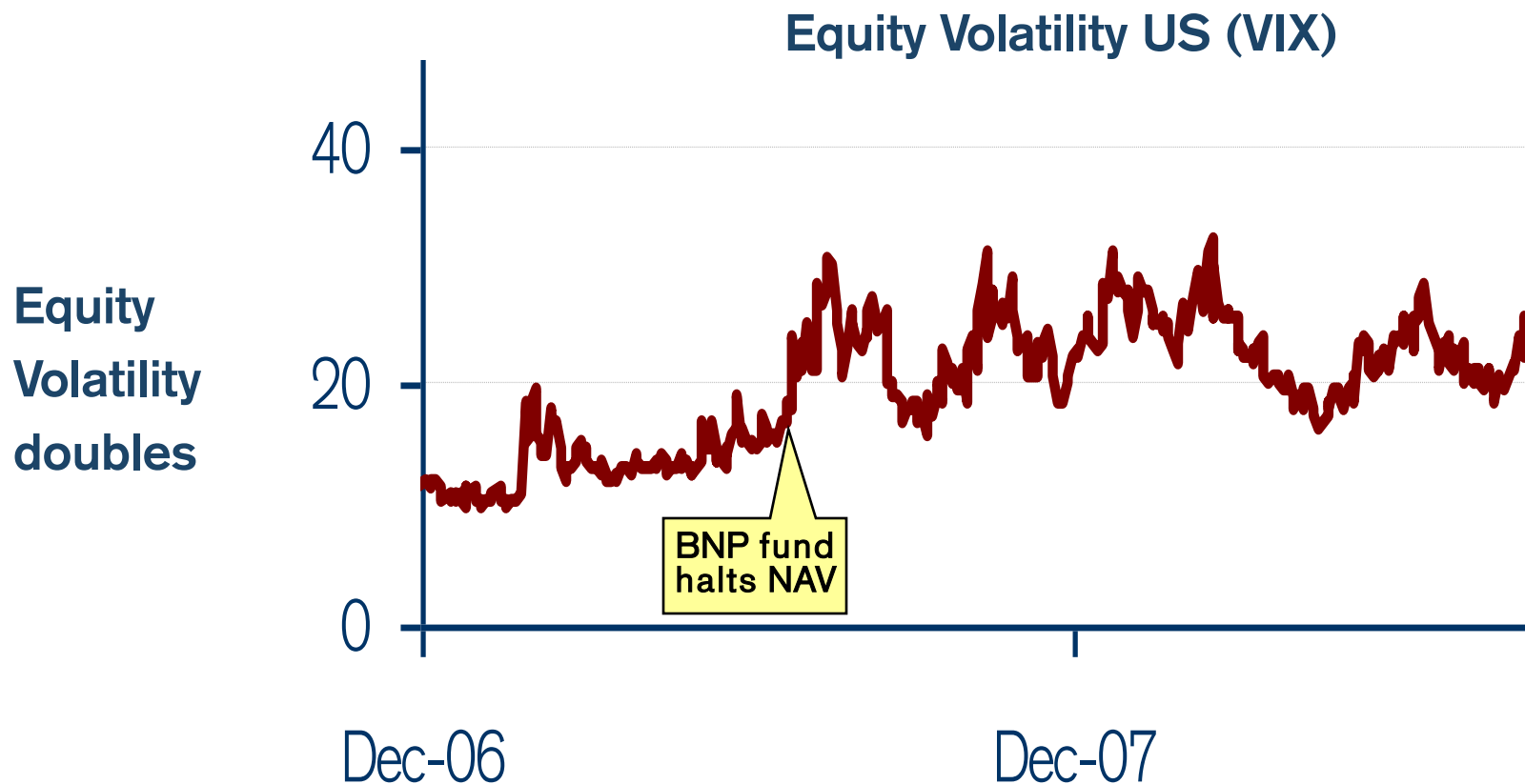
1. Asset class crisis
(mortgages, esp. US)

➤ Leading to stress in
the funding markets



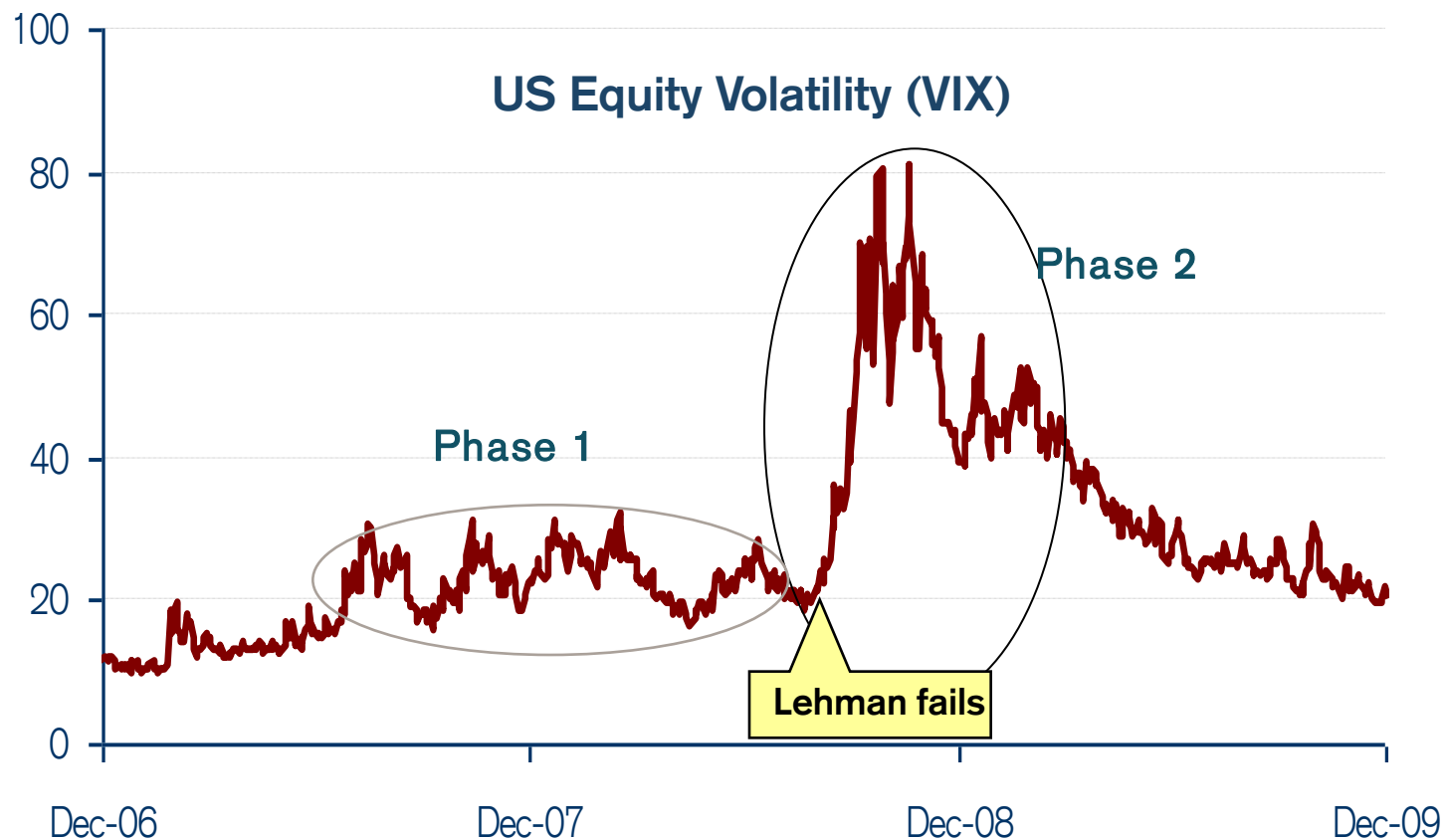
Phases of the GFC

1. An asset class crisis
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Phases of the GFC

1. An asset class crisis
(mortgages, esp. US)
- 2. Wall St fails**

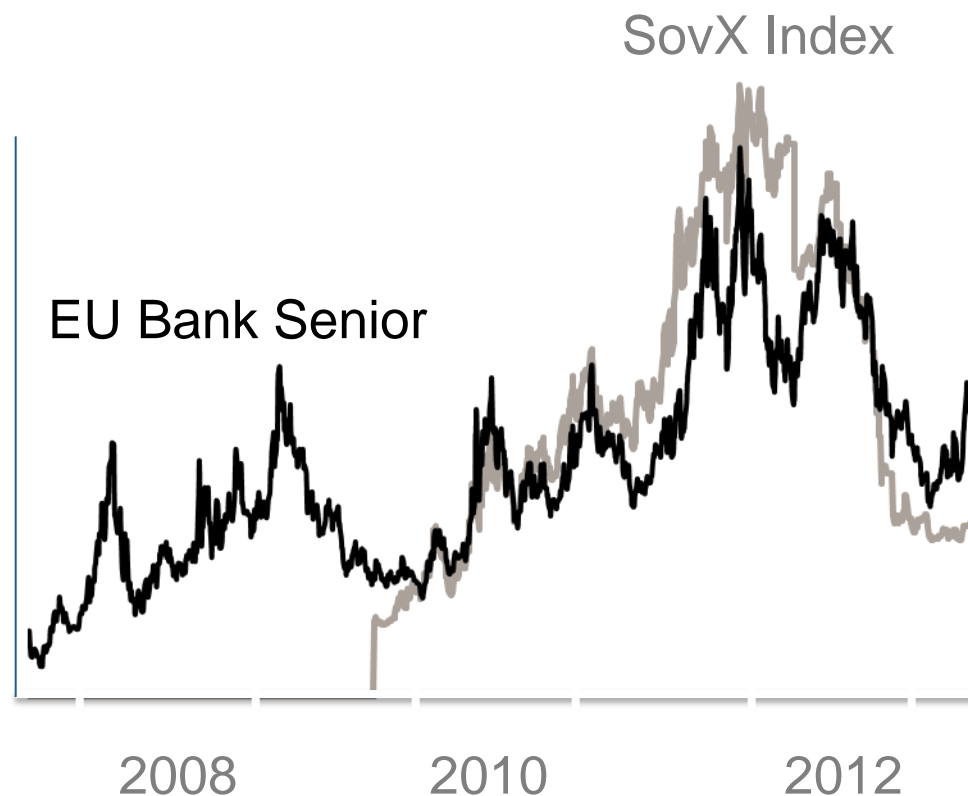


Phases of the GFC

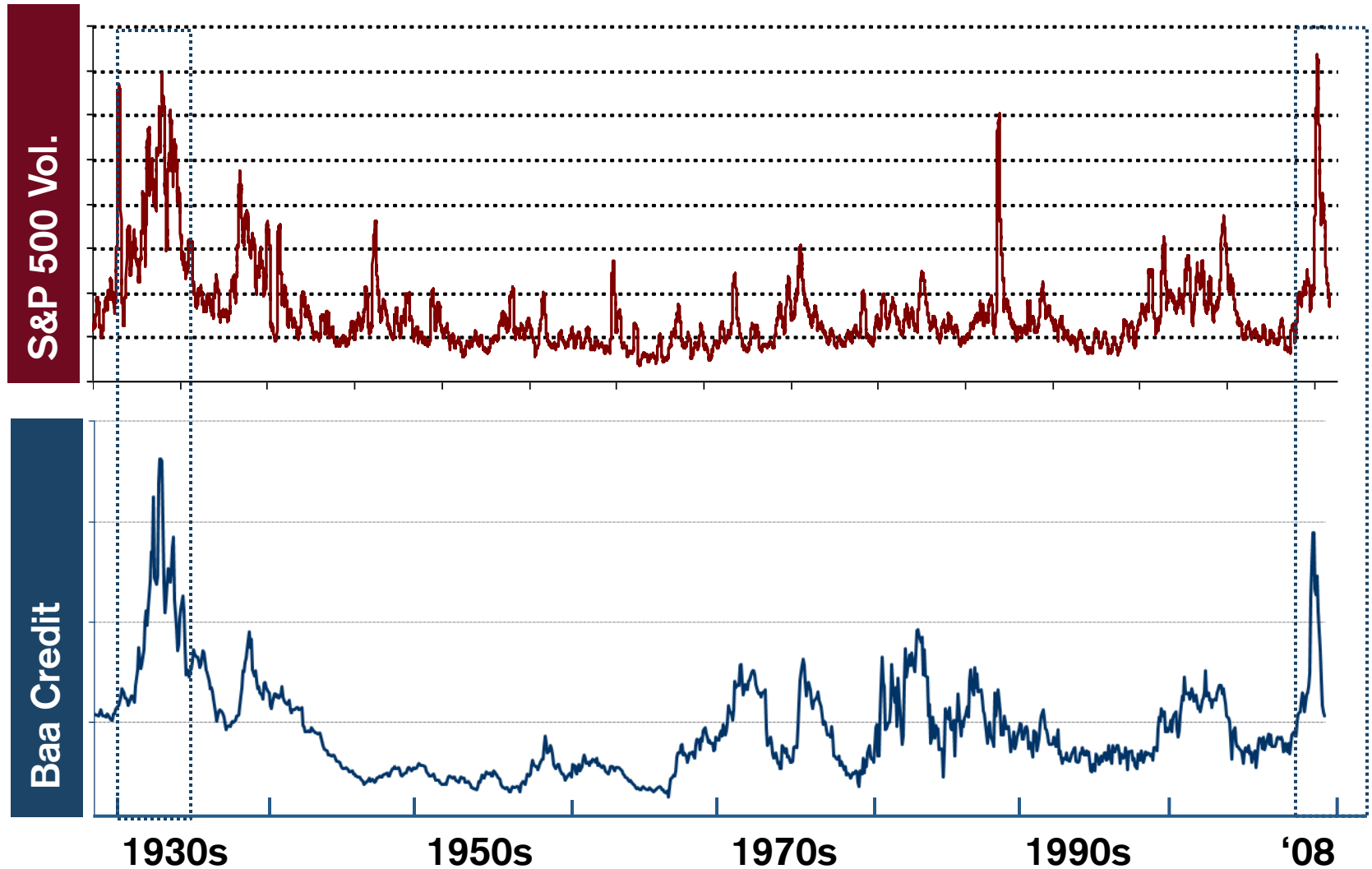
EU didn't have a bad Phase 2. . .

- Extensive use of sovereign support suppressed risk
- However success was only temporary in many markets
- Bank – sovereign “doom loop” → Phase “2b”

EU
Credit
Spreads



Long run proxies for market stress



Observations

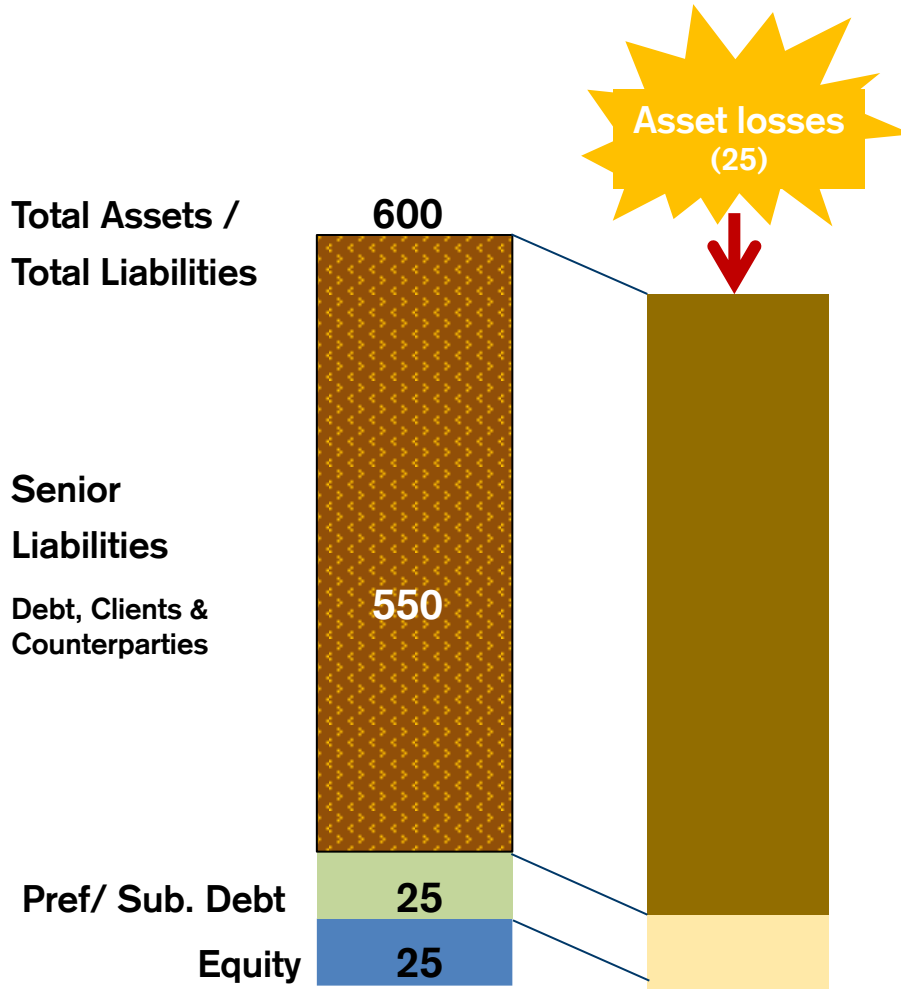
- Markets - though highly stressed - continued to function in Phase 1
- Inability / Unwillingness of USG to avoid Phase 2
 - Lehman “test case” *
 - Systemic risk dial → “eleven”
 - EU could delay - but not avoid - P2
- Dramatic difference in stress levels between Phase 1 & Phase 2
- Environment changed from an “asset shock” → “systemic crisis”



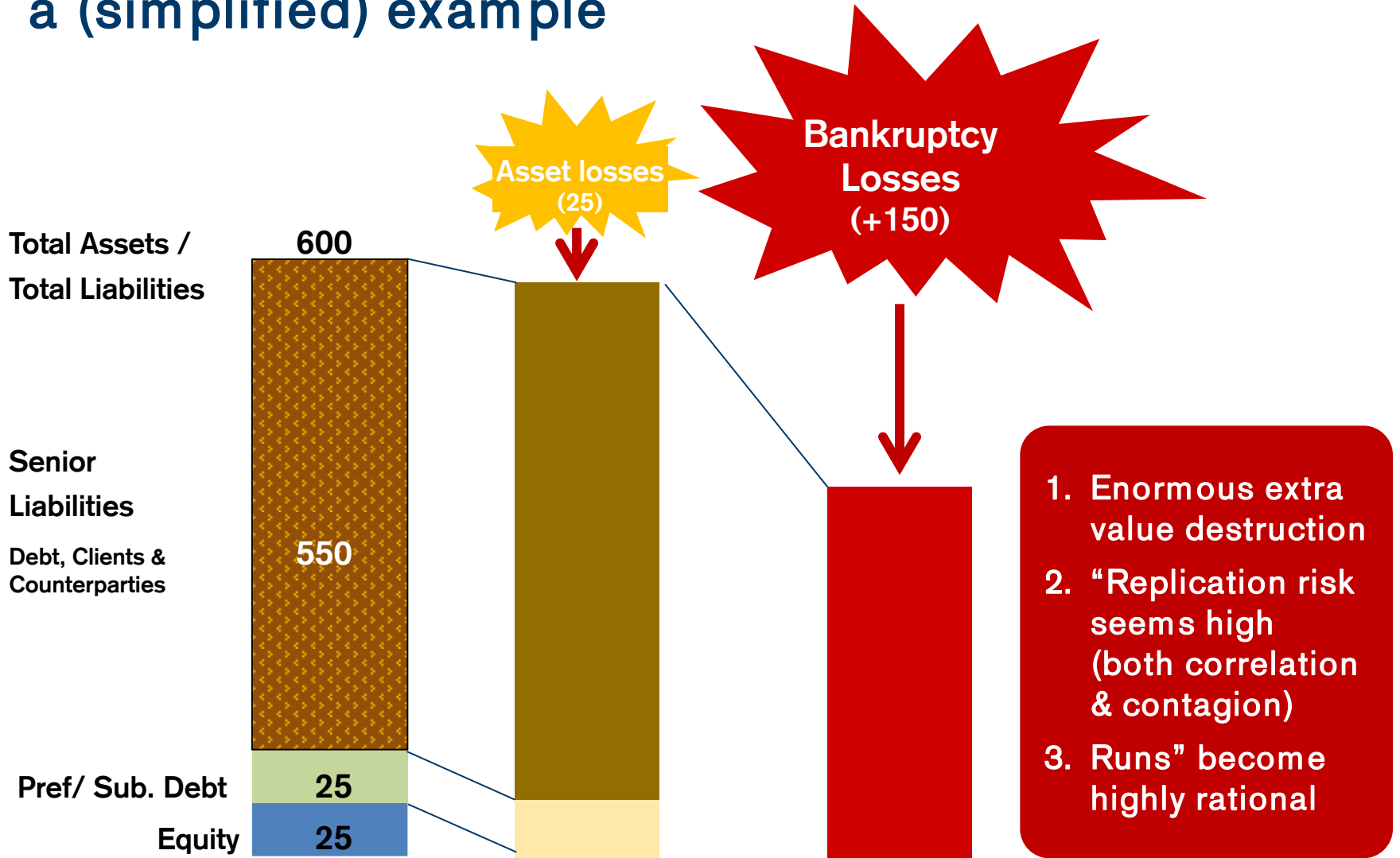
* more on this later

How resilient are the components of the financial system?

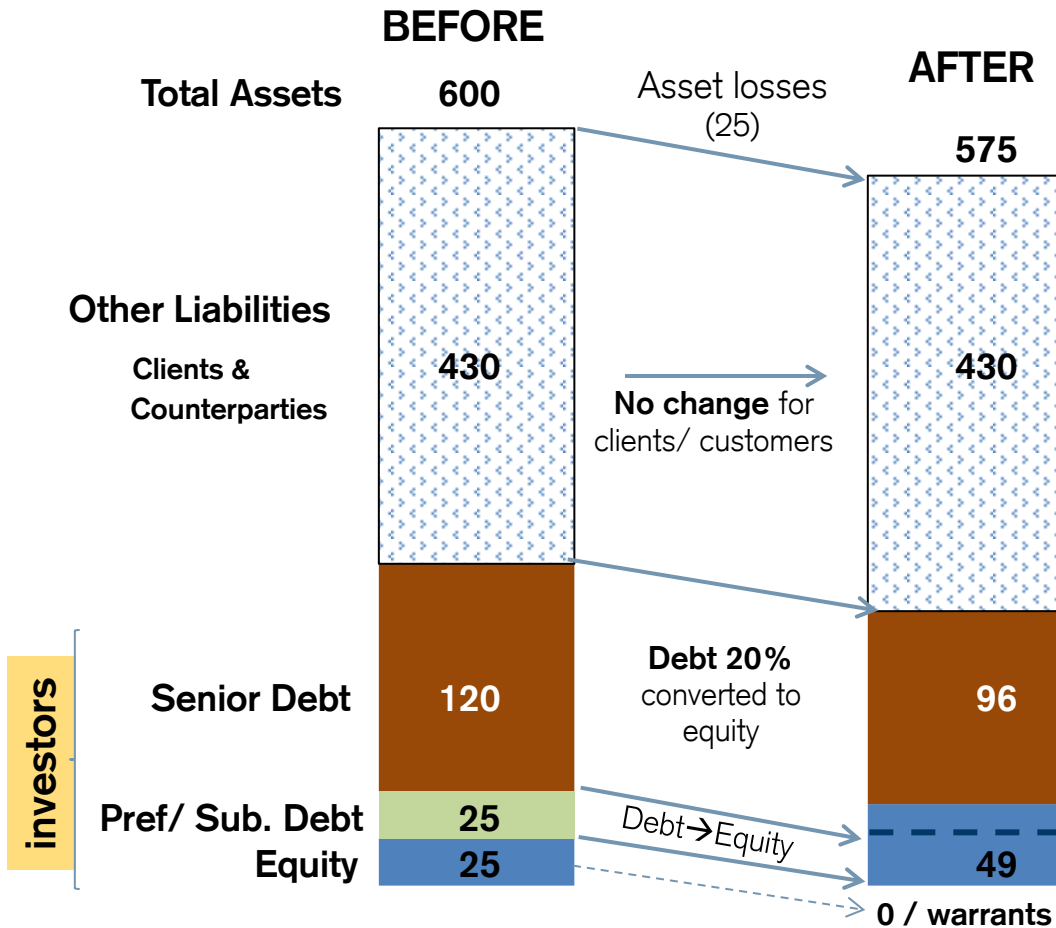
Too Big To Fail? a (simplified) example



Too Big To Fail? a (simplified) example



An Alternative: The "Bail-in" concept - a (simplified) example



Key Elements

1. Fast "Chapter 11" recap
2. Re-cap investor capital for losses AND strong new equity (25→0→49)
3. Preserve value via "going concern" strategy
4. \$ Losses << liquidation
5. No loss of key functions

Restores resilience to key system components

Crises and firebreaks

Eliminating all asset shock “fires” is hard

- Phase 1 stresses will be hard to end
- Dampening asset markets can lead to other risks – (“meta-risk” a la Minsky)

Phase 2 is far more destructive, but solution appears more tractable – if done well

Bail-in can insert a critical firebreak vs. Ph 2

- Restores resiliency to key components
- Firebreak against systemic propagation
- Can also dampen the “bank-sovereign” feedback loop

