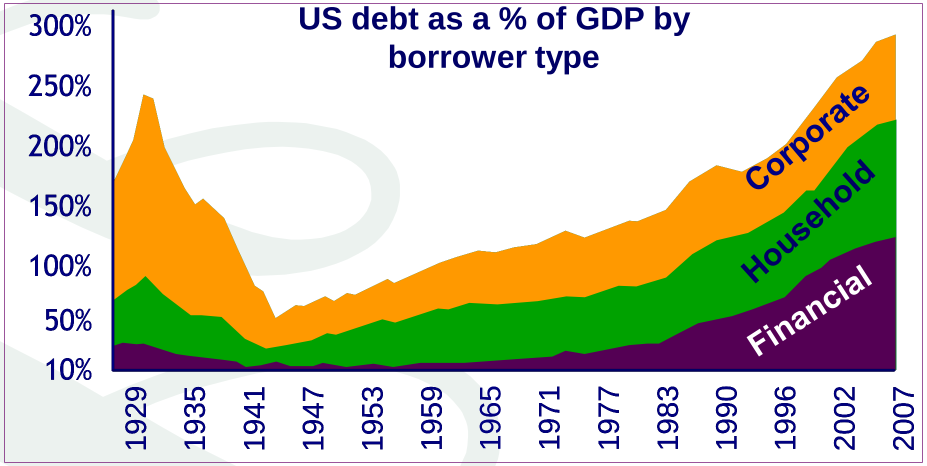
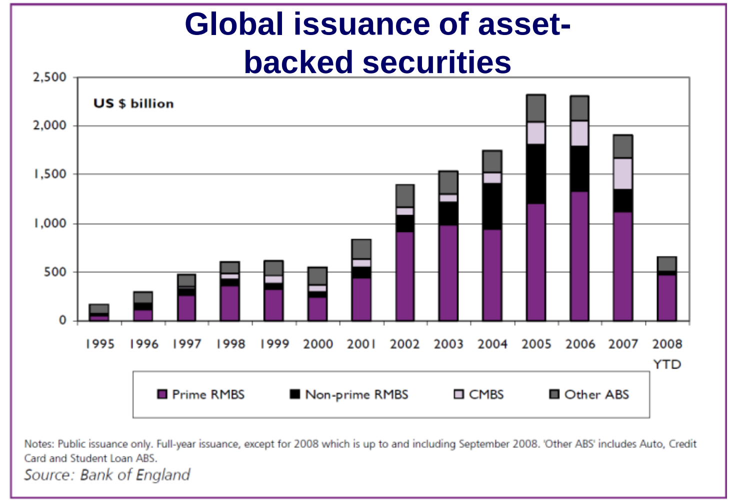
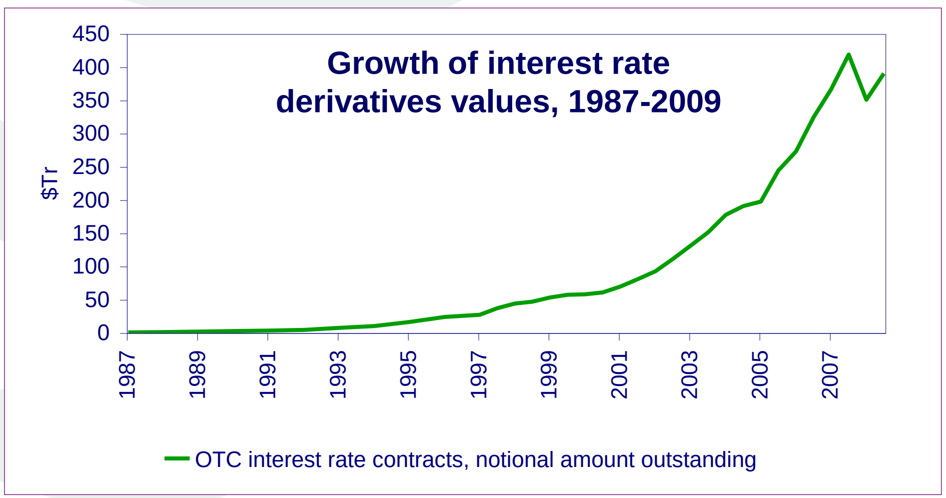
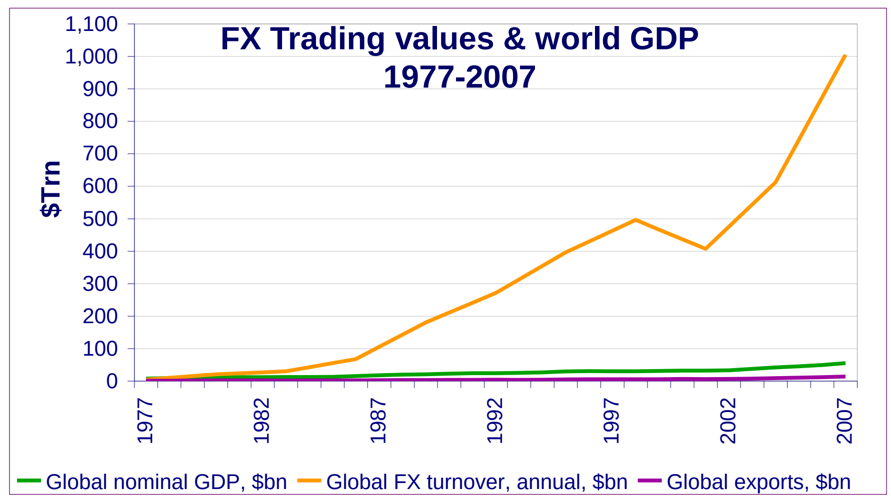
Measures of increasing financial intensity









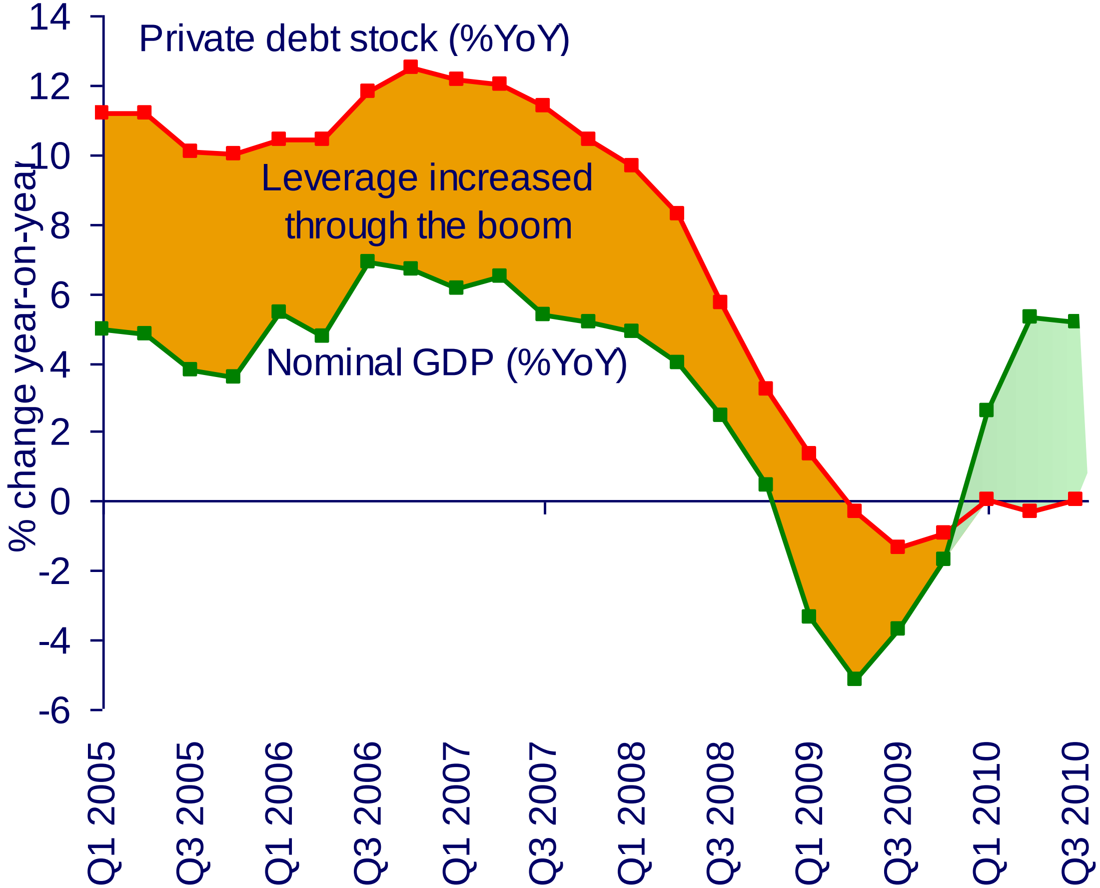
IMF estimates of public support costs in 2008-2009 financial crisis

% of GDP

	Pledged	Utilised	Recovery	Net direct cost
Advanced economies	6.2	3.5	0.8	2.8
Emerging economies	0.8	0.3	-	0.3

Source: IMF: *A fair and substantial contribution by the financial sector,* June 2010

Growth in lending and nominal income: UK 2005 – 2010



Mechanisms to increase loss absorption capacity and market discipline

Capital surcharge and/or sub debt convertibility

Increase role of loss-absorbing capital

Bail-inable senior debt

Smooth resolution without disruption

OR

'Reserve army' of capital to cover extreme events

Resolvability & statutory bail-in

Resolution procedures which can rapidly impose losses/conversion on all liabilities (to extent required)

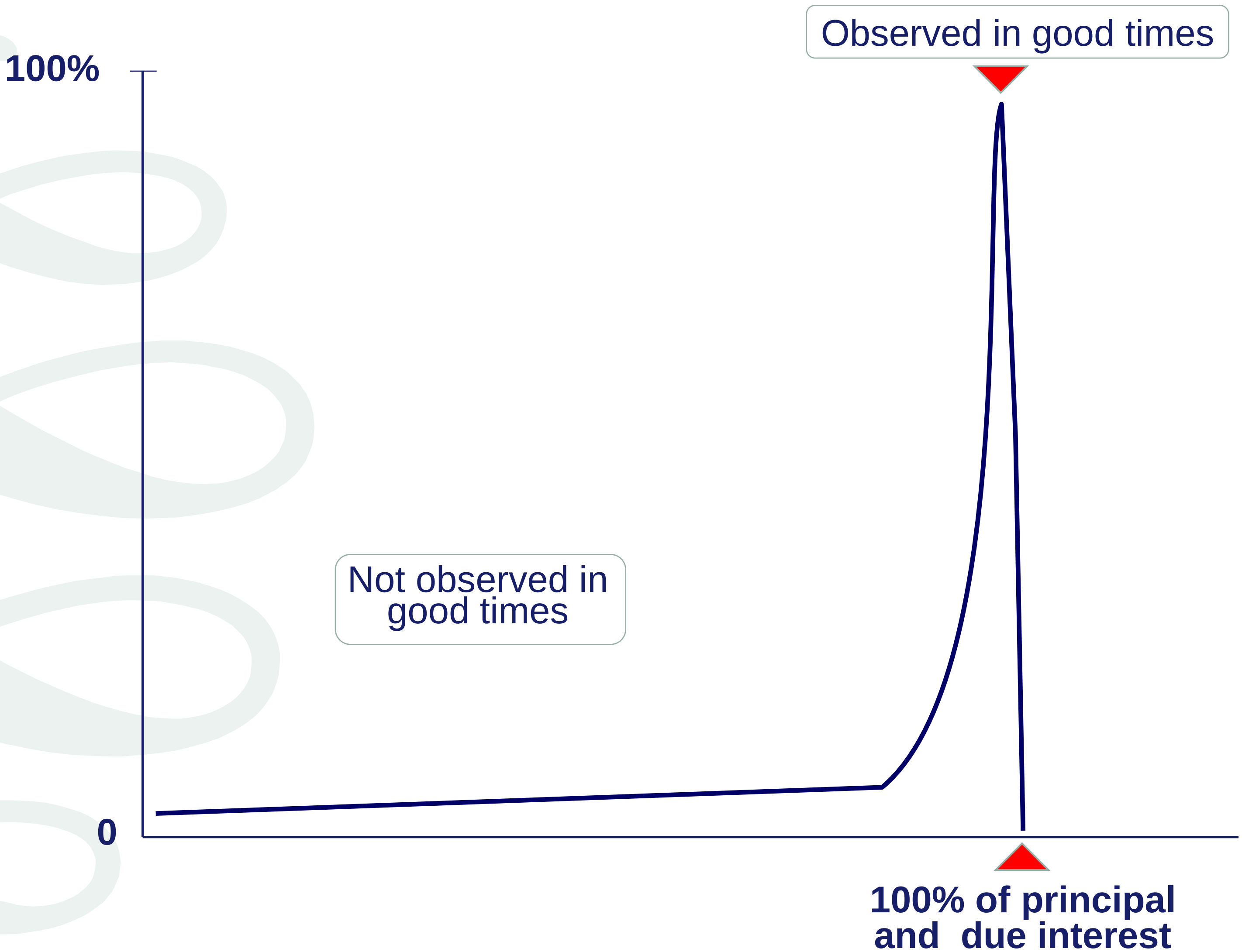
TBTF: Conditions for success of debt based solutions

- Large enough % of balance sheet junior to depositors
- Subject to write-down/conversion to equity in smooth process
- Long enough in maturity to avoid pre-crisis runs
- Held outside banking system and by investors able to take losses without knock-on asset fire-sale or debt default consequences

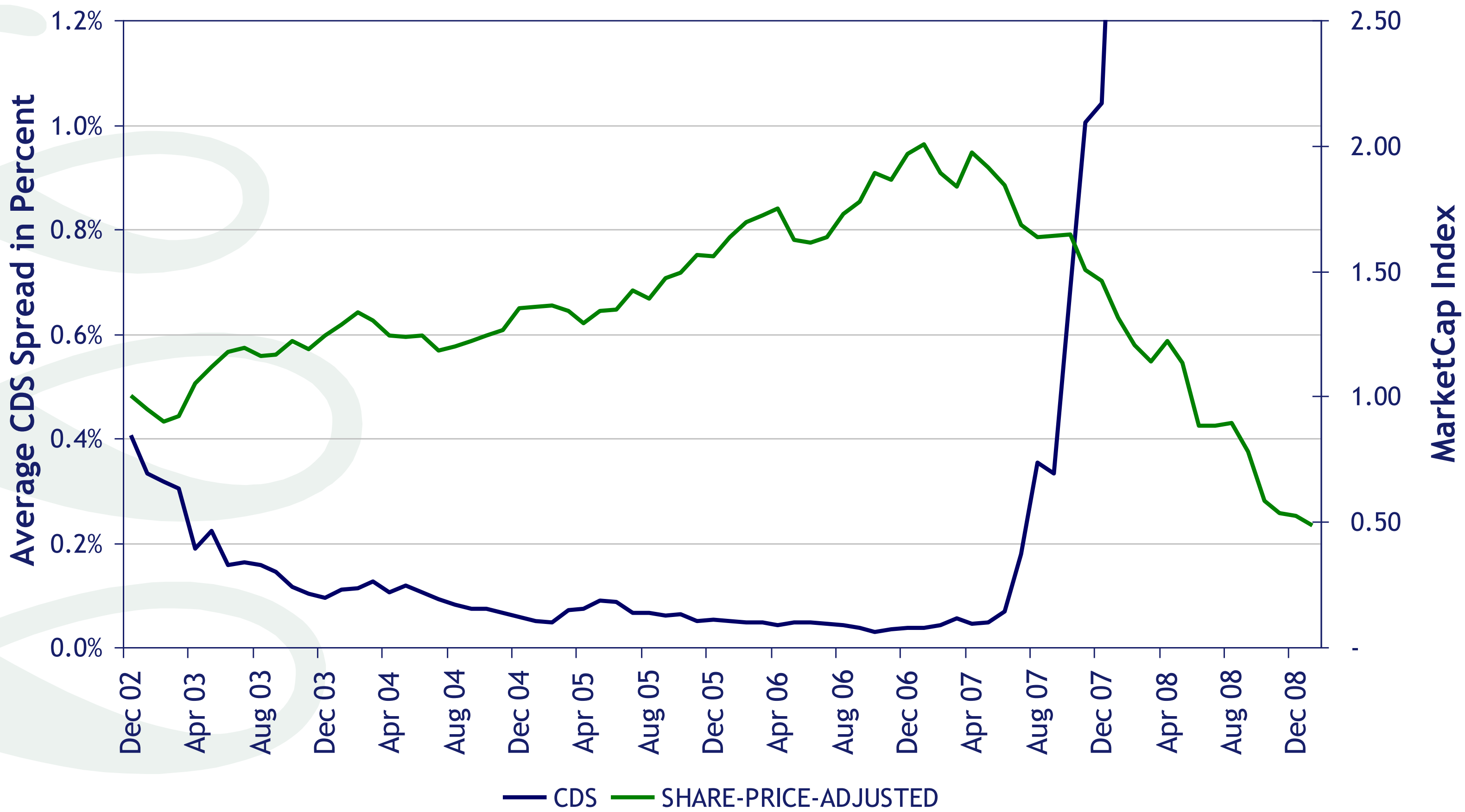
Required to address idiosyncratic failure of SIFI

Additionally required to address systemic risks of multiple failures

Frequency distribution of bank bond payouts



Financial firms' CDS and share prices



Firms included: Ambac, Aviva, Banco Santander, Barclays, Berkshire Hathaway, Bradford & Bingley, Citigroup, Deutsche Bank, Fortis, HBOS, Lehman Brothers, Merrill Lynch, Morgan Stanley, National Australia Bank, Royal Bank of Scotland and UBS.

CDS series peaks at 6.54% in September 2008.

***Source*:** Moody's KMV, FSA Calculations

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Rigidities and vulnerabilities of debt contracts

- Bankruptcy costs: non-smooth adjustment
- Fire-sale costs
- Need for continual roll-over
- Multiple equilibria depending on interest rate
- Credit and asset price cycles

Measures of increasing financial intensity