Preparing G20 – London

New Financial Order: Recommendations by the Issing Committee

Beim G20-Gipfel der Regierungschefs am 2. April 2009 in London will die Bundesregierung den im Februar vorgelegten zweiten Bericht der von ihr im Oktober 2008 berufenen Expertengruppe „Neue Finanzarchitektur" mit in den Verhandlungsprozess einfließen lassen. Die Redaktion veröffentlicht die Zusammenfassung einschließlich der Empfehlungen im Wortlaut. Das gesamte Papier ist unter www.ifk-cfs.de sowie unter www.bundesregierung.de abrufbar. (Red.)

Our first report gave a broad overview on the causes of the financial market crisis and presented a number of recommendations for improving the framework („New Financial Order"). A number of our recommendations were more or less straightforward and in line with those by other groups and institutions.

Our Report was well received and finally published. We are grateful for feedback from many sides. After a very fruitful interaction with the government we were now asked to expand our analysis on several issues. This second report does not cover again a broad set of aspects but concentrates on several important topics. These refer to the proposal for a risk map and a credit register, to regulation and supervision of hedge funds and rating agencies, the problem of procyclicality, and the role of international institutions and fora.

1. Intelligent Transparency

Many studies and statements have come to the conclusion that the financial market crisis to a large extent is caused by a lack of transparency which contributes to asymmetric information, leads to misallocation of risks, fosters destabilising compensation schemes et cetera. On issues of systemic importance, information is incomplete or relevant data are just missing.

Greater transparency therefore is badly needed to avoid pitfalls of the past and improve the framework of a new financial order. But greater transparency does not and must not mean just collecting more and more data and providing additional information. A myriad of data is already available, just adding more and more statistics might rather lead to confusion than improving transparency, not to forget the costs for reporting and data collection. Data have to be collected more systematically and with a clear orientation on the purpose for which they are needed. We call this "intelligent transparency". The focus in this concept is on the proposal for a Risk Map, but also refers to a number of other issues.

2. Risk Map

The current crisis has been characterized by the fact that the relevant authorities (Central banks, supervisors, deposit insurers) were not fully aware of the extent, the interconnectedness, and the systemic risks emanating from the shadow banking system. This shadow banking system had evolved over the past couple of years, comprising off-balance sheet entities as well as risk transfer instruments like CDOs and CDS. In fact, available data bases are not prepared to capture these financial instruments, nor the international interconnectedness among large and complex financial institutions (LCFI). Therefore, as a prerequisite for strengthening counter-cyclical policy measures (e.g. capital adequacy, and liquidity reserves), a coordinated effort to set up a suitable data base of the global financial interconnectedness (the exposure net) and its major risk factors (the risk drivers), is needed. Such a Risk Map constitutes a much needed push to enable an effective macro-prudential policy targeted at crisis prevention and crisis management (discussed in more detail in section 5 of this report).

Recommendations:

- Macro-prudential supervision (i.e. systemic stability supervision) should become a major objective of banking supervision, complementing the traditional microprudential supervision.

- Chaired by the IMF, and complemented by an inter-agency task force, a proposal should be developed defining the conceptual back-bone of the Risk Map project. The participating agencies should have a proven record of regional expertise as, for example, the ECB and the ESCB in the case of Europe. One key issue relates to data specification, i.e. micro and macro data enabling an operational framework for financial stability assessment. The second key issue relates to data access and data use, i.e. a common understanding of how these data can be used, encompassing the most important countries and their agencies (central banks in particular).

- One lesson from the current crisis is also that data analysis alone does not suffice to spur appropriate market discipline and to trigger interventions by regulators and supervisors. What is needed instead is a pre-arranged link between the results of the data analysis and a set of policy actions. On the basis of the Risk Map, we propose to establish a hard-wired policy rule linking the systemic risk assessment to a suitable policy action, e.g. bank capital requirements.

- Furthermore, in order to assure the continuous consideration of systemic risk assessment by policy makers, the Risk Map analysis will regularly be discussed at G20 (finance minister) conferences, or at IMFC meetings.

3. Credit Register

Credit registers which collect firm exposures vis-à-vis financial institutions, work efficiently at a national level only. Given the current high level of international lending and exposures, a global credit register will greatly enhance risk management, both at the firm level (improving due diligence of cross-border exposures), and at the systemic level (adding a cross-border dimension to financial stability stress testing, and to an evaluation of real effects on the economy). In a similar way, a unified approach to exposures vis-à-vis bonds and stocks will add the international capital market dimension to the picture of corporate and bank risk exposures. Credit register information extends the information aggregated under the Risk Map project in the direction of major bank borrowers.

Recommendations:
• We propose a centralized approach to setting up a standardized credit register that is capable of mapping domestic and cross-border exposures simultaneously. These registers will require a standardization effort by all participants. It may well be covered by the Inter Agency Task Force, which we have proposed for setting up the Risk Map.

• Likewise, the advancement of a global securities register, itself closely related to the Risk Map project, should be continued in parallel, exploiting possible synergies. The existing Working Group on Securities Databases WGSD should be cooperating with the Risk Map project.

4. Hedge Funds

Hedge funds tend to take large risks, often accompanied by high leverage. However, these risks are not necessarily systemic risks. In view of the current market situation, there is no indication yet of a prominent role of hedge funds in the genesis of the crisis. However, hedge funds played a role in crisis transmission, due to their strong reliance on bank financing and maturity mismatch. In the crisis, these characteristics contributed to procyclical behaviour, in particular to deleveraging and asset sales, which both had a negative impact on market liquidity.

Recommendations:
In weighing the arguments presented in the preceding section, we propose a mixture of direct and indirect hedge fund regulation, i.e. a gripper approach, having two levers.

• Direct regulation is the first lever, referring to hedge fund registration, combined with the collection of structural data (including a unique identifier, domicile, ownership structure, management advisor, investment objectives). The hedge fund data base will be stored in a publicly accessible register, possibly as a part of the Risk Map project. The structural information can (and should) be complemented by balance sheet information on a quarterly or annual basis (e.g. asset under management and capital structure)*. A reasonable size threshold above which registration and reporting requirements apply has to be set, e.g. 100 million US-Dollars assets under management (AUM).

• Indirect regulation is the second lever. The actual systemic risk oversight should be directed primarily at the major banks providing funding, counterparty positions and transaction services to single hedge funds (prime brokerage). The emphasis will be on monitoring counterparty risk management by prime brokers, including leverage ratios, and by looking after a sufficiently large capital base to cover the risks involved. The first lever, above, provides the necessary information to link any registered hedge fund with all of its brokers, thereby viewing the consolidated exposure of the financial system vis-à-vis hedge funds.

• Concerning funds domiciled in offshore centers, indirect regulation should factor in any risks emanating from counterparties (i.e. hedge funds) not subject to direct oversight, i.e. the first gripper described above. This policy will make the choice of offshore centers as the domicile for hedge funds less attractive.

5. Rating Agencies

The recent past has seen a highly disappointing performance of rating agencies in the new debt markets, whose explosive growth they have enabled. By carrying over a well-established methodology from bond markets to more complex, structured finance products, the rating firms acted thoughtless, and indeed irresponsible, eventually wreaking havoc to the agencies' credibility. Given the important functions rating agencies are fulfilling in debt markets, the regulatory response to the current crisis has to aim at re-building their reliability and credibility. The issues at stake are: conflict of interest, compensation, transparency of the rating methodology, and rating performance.

Recommendations:
• Registration and rating depository: Internationally active rating agencies should be registered with an institution entrusted with capital markets oversight, e.g. the IMF or the BIS.

• On a regular basis, agencies are required to deposit their rating assessments with the entrusted institution. The latter takes responsibility for a profound statistical analysis of these data, publishing regularly rating default tables and rating migration tables. Such tables are the basis of an official performance measurement of all internationally active agencies, in order to facilitate an inter-agency comparison of their predictive performance.

• These assessments should be disclosed to markets and investors.

• In addition, we propose to hold a high-level, open annual event that discusses the status of the rating industry and its performance. The use of designated expert panels in a public dialogue with issuers, investors and regulators should help to maintain the right level of awareness, and to stimulate regulatory and industry debate about rating practice.

6. The Poblem of Procyclicality

Procyclicality is the term used to characterise financial and economic systems prone to credit driven phases of boom and bust. In the boom phase, rising optimism about the economy leads to an expansion of credit which drives up asset prices, encourages spending, and leads to more optimism in turn. These patterns eventually prove inconsistent with underlying fundamentals, and the bust phase follows, often triggered (and made more serious) by a sharp tightening of credit standards by those left exposed to imprudent loans made earlier. These big cycles have been seen repeatedly in history. Moreover, there is ample microeconomic evidence of procyclical behavior on the part of virtually all the economic agents, both private sector and public sector, that have contributed in some way to the current global downturn.

Recommendations:
• Central banks and regulators should agree that procyclicality is a serious problem, and that identifying and responding to the build up of systemic exposures should be a priority for all concerned. In effect, "preemptive tightening" should replace what has been the preference in recent decades for "preemptive easing".

• There is a need to develop a set of indicators , using both macroeconomic aggregates (macrosystemic indicators) and data indicating growing stresses within the financial system (microsystemic indicators), to alert policymakers of rising systemic exposures. The "Risk Map" project is directed to this end.

• Policymakers should lean against these rising exposures using the instruments available to them, both monetary and regulatory. For both, this will imply significant changes to how they currently behave. Given how hard it will be to use available instruments in a discretionary way, an initial recourse to rules based reactions has much to recommend it.

• Central bankers and regulators, both nationally and internationally, must co-operate more systematically if the problem of global procyclicality is to be dealt with effectively. If significant progress on these issues could be made within Europe, the potential for global solutions would be much enhanced.

7. The Role of International Institutions

The New Financial Order requires efficient global cooperation and well-functioning international institutions and fora, in particular with respect to the International Monetary Fund (IMF), the Bank for International Settlements (BIS) and the Financial Stability Forum (FSF). To strengthen the role and effectiveness of these bodies, two broad issues need to be addressed: Their legitimacy because the current composition of their decision-making bodies is no longer accepted by the largest emerging market economies (EME); and the focus of their work which should be aligned to deal with the key weaknesses of the old system.

Recommendations:

• Improve the legitimacy of the relevant international bodies. This implies:

– For the IMF: to continue the process of quota adjustments in favour of EMEs. In addition, more of the Fund's Executive Directors should come from developing countries. In this context, the European representation on the Board should be reconsidered.

– For the BIS: the key committees of the BIS should be expanded beyond G10 countries to include the largest EMEs, such as China, India and Brasil, as full members.

– For the FSF: as already agreed by the G20, the membership should be expanded. However, the number of countries participating fully (with three representatives) should not increase too much in order not to loose efficiency. It will be important to find the right balance between legitimacy and efficiency.

• Re-focus the work of the IMF, BIS and FSF while maintaining the existing division of-labour between these institutions:

– The IMF should intensify its work on financial market issues, in particular on the spillovers between financial markets and the real economy, the assessment of macro-prudential risks, the collection of financial market data and the monitoring of the implementation of agreed standards and codes;

– The BIS-committees should adopt decisions to close gaps in the regulatory and supervisory system and to tighten capital requirements and should review the procyclicality of the system;

– The FSF, with an expanded membership, should use its unique experience to identify gaps in the regulatory and supervisory system and guide the implementation of reforms carried out by its members.

– In principle, IMF, BIS and FSF should cooperate closely on issues related to systemic risks, macro-prudential risks and on ways to reduce the procyclicality of the regulatory and supervisory system.

• Mandate the IMF, BIS and FSF to develop a better early-warning system, using their respective expertise. A better early-warning system should incorporate the insights gained from the Global Risk Map and the international credit register proposed earlier in this report.

– As one element of a better early-warning system, IMF and FSF could produce and publish a joint annual International Financial Stability Report (as proposed by the Deutsche Bundesbank).

– IMF member states should acknowledge that early-warnings are only effective if such warnings are taken into account early-on in economic policy decisions.

• Develop a more robust macro-economic policy framework, with implications for the conduct of fiscal and monetary policies, to help prevent the next crisis. This will be of particular importance during the next few years, after the end of the current crisis, as policy-makers have to find an exit from the exceptional fiscal and monetary policy measures that are unavoidable under current circumstances. If, during the next decade, policies do not compensate for the exceptional stimulus given now, public debt might become unsustainable and/or high levels of inflation might return in some countries. Consequently,

– the IMF should take the lead in designing a "Global Stability Pact" for the conduct of fiscal policy (as proposed by Chancellor Merkel);

– the BIS should take the lead in designing elements of a more robust monetary policy framework without compromising the independence of central banks.

• Increase the financial resources of the IMF:

– In the short-term, the GAB and NAB should be increased, possibly doubled and the membership of the NAB should be broadened to include all G20 countries.

– In the medium-term, the quotas of the IMF should be increased substantially. A large quota increase will also make it easier to accommodate a shift in relative quotas in favour of EMEs.

* Balance sheet information is not collected on a continuous basis, respecting proprietary information of the funds. Limiting data collection to annual or quarterly data, in line with the Risk Map project, is also reasonable for capacity reasons.

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