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Balancing risk taking and financial regulation

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The Global Economy

Balancing Risk Taking and Financial Regulation

The Challenges

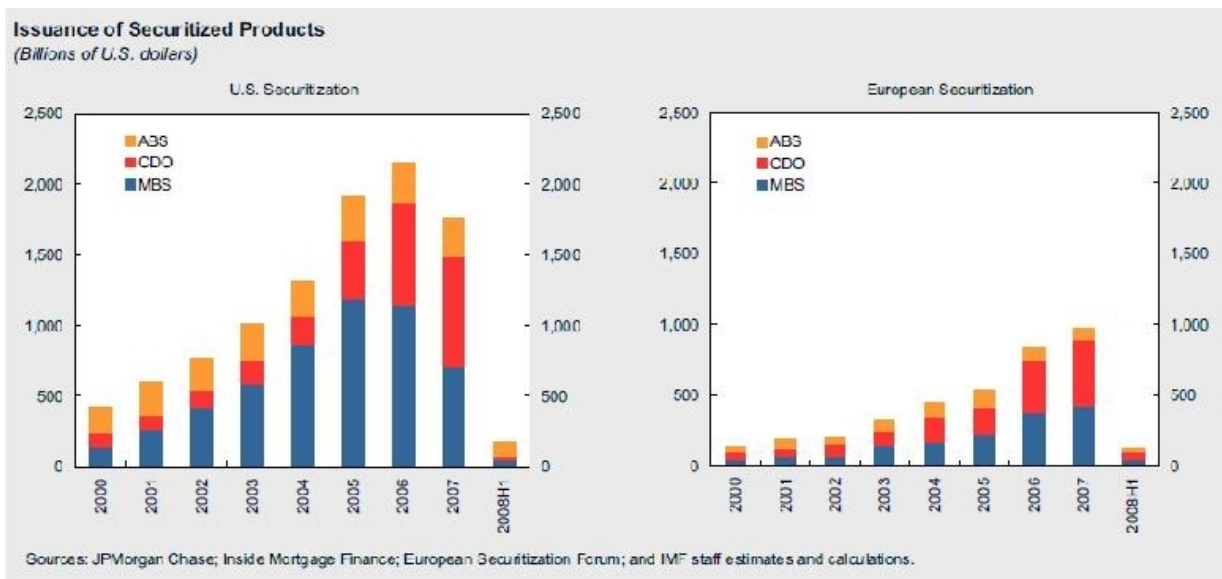
Many observers blame excessive risk taking and inadequate regulation as the core causes of the current global financial crisis that we have been witnessing.

Consequently, in the aftermath of the massive efforts by governments to rescue financial firms that were hard hit by the global crisis, the re-regulation of global finance has surfaced in many of the comments or policy proposals made by policymakers, the academic as well as business communities.



While such sort of reaction is to be expected, it raises several questions.

- First, how far should re-regulation of global finance go without stifling healthy risk-taking and financial innovation (e.g., securitized mortgages, securitized credits)?
- Second, should tighter regulation be across-the-board or case by case? Should regulation be tailored to specific financial products (mortgages, credit card loans, secured vs. unsecured debt etc.) or financial industry (commercial banks, investment banks, hedge funds etc.)?
- Third, which regulatory instruments require multilateral coordination? For example, is it sensible to have a single standard for minimum capital requirements or deposit insurance scheme for internationally active banks?
- Fourth, how can regulators give the right incentives for bank stakeholders (investors and creditors) to be active in monitoring risk taking by banks, and thereby reducing the risks of credit defaults?
- Finally, how should regulators push for more transparency of banks' exposure to risk, without compromising the confidentiality of banks' risk control strategies?





Proposed Solutions

Paul Achleitner

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Using insurance as an alternative to the bad bank

The current situation

In spite of the German Special Fund Financial Market Stabilization (SoFFin) guarantees extended to German banks to refinance them (not to mention the measures taken to increase tier 1 capital), German banks are becoming increasingly reluctant to lend money, and this reluctance, together with the downturn in the economy, is putting a great strain on the German economy.

One of the main reasons for this is that there are types of assets in banks' nontrading portfolios (less so in their trading portfolios) that are increasingly tying up capital as ratings are lowered. "Rating migration" will continue to have a negative impact on banks' risk-weighted assets (RWAs) and will make banks even more reluctant to lend money. This is why the German government has been discussing, for some time now, whether to establish one or several "bad banks" to which banks could shift their "problem assets." Apart from it being difficult to manage such a solution, it would also involve cash flow and rating problems. The German government has thus decided (and to my mind, rightly so) not to "sponsor" such a solution.

The insurance alternative

The government could establish a government-owned insurance company (with guarantor liability) to solve the problem. This company would charge premia to insure banks' problem assets against actual failure when they reach final maturity (!). That is, the problem assets would stay with the banks and continue to be managed by the banks. The actual value of an asset would be calculated not before it reaches maturity (for example, when a structured, mortgage-based asset reaches maturity) using the cash flow generated by the asset. Depending on the type of insurance a bank has chosen (asset types could be differentiated), the bank would have to absorb a deductible and pay a proportion (e.g., 10%) of the loss covered by the insurance company.

The advantage to this is that it would provide capital relief equalling the amount insured without federal funds having to be used from the outset. The banks would continue to manage their financial products, which are usually quite complex, and would be motivated by deductibles and coinsurance fees to minimize their final losses (and of course would be required to submit to audits and to account for their assets ("ring-fencing").

The rating problem

One of the main problems in selling problem assets is the current volatility and liquidity-engendered distortion of market prices. Since the insurance alternative would not per se involve selling assets, an across-the-board solution could be used which would take into account the amount insured and which could possibly be differentiated according to asset types or ratings.

Determining the premia

Here it would be possible to be creative. The base case would be a premium amounting to x% of the insured assets, payable in advance in cash. Depending on the size of the portfolio involved and the bank's liquidity situation, payment of premia could of course be deferred (even until final maturity). The British government, which intends to insure huge amounts of



money, is going so far as to accept newly issued tier 1 capital as premia. This will also strengthen the capital position of the banks. In order to prevent cherry picking, insurance could be offered only for complete categories of assets (e.g., leveraged buy out (LBO) loans, residential mortgage-backed securities (RMBSs)).

Other considerations

- Of course, there are a number of issues that would need to be dealt with before the insurance alternative could be implemented. Here are some of these issues:
- A solution of this type could also help to put an end to one of the worn-out arguments against consolidating the Landesbanks.
- Since an insurer is generally viewed according to its capital (which is relatively small because of guarantor liability) or premium volumes, it could also be possible to get away from nominal, or guaranteed, amounts that are hardly understandable for the normal person anymore (this issue would have to be discussed with budgetary law experts in order to find a solution conforming to the law).
- It is still an open question where it would be best to locate such an insurance company (at SoFFin, KfW, a new institution, etc.) and what would be the best name (failure insurance, surety insurance, capital protection insurance, relief insurance, or something-else insurance).
- While running the risk of talking the concept to death, one would like to point out that an insurer that ensures financial products against losses at maturity could of course also insure industrial companies' assets (or loans?).

Illustration

Bank x has problem assets on its balance sheet amounting nominally to 100. These assets are insured against a premium of 5%, with a 15% deductible and a 10% coinsurance fee. This means that the first 15% of a loss is assumed by the bank itself, beyond that it assumes 10%.

Amount of Loss Assumed (including premia) at the Bank and the Insurance Company

Final Value of Asset	Bank	Insurance
100	-5	5
90	-15	5
80	-20,5	0,5
70	-21,5	-8,5
60	-22,5	17,5
50	-23,5	-26,5
40	-24,5	-35,5
30	-25,5	-44,5
20	-26,5	-53,5
10	-27,5	-62,5

Josef Ackermann

Chairman of the Management Board and the Group Executive Committee, Deutsche Bank AG

Challenges

The financial crisis has, so far, caused losses in the financial sector exceeding US-\$ 1 trillion, wiped away US-\$ 1.2 trillion in the market value of the top-20 financial firms alone and forced governments to provide US-\$ 3.6 trillion in funds for rescue measures. It has also triggered the



deepest global recession since the end of World War II. Reform of the global financial system is needed and must provide solutions for the following questions:

- How can we resolve the incompatibility between open, integrated financial markets and the fact that financial regulation, the tools for crisis management and the ultimate resources for rescue operations are still essentially anchored at the national level?
- How can we strike the right balance between safeguarding financial stability, on the one hand, and maintaining the innovative power of financial markets, on the other?
- What is the right balance between limiting the systemic risk that individual institutions can cause, e.g., by limiting their size or the range of activities they can engage in, and exploiting the benefits that large and diversified financial institutions can provide for their clients and for financial stability?
- What is the right balance between a consumer's individual responsibility, also with regard to their choice of financial products, and the need to protect unsophisticated consumers from unsuitable selling activities and products that are too risky for them?
- How can we phase in tougher rules for the financial industry so that it does not stifle the impending recovery?
- What are the right exit strategies for the current, massive government assistance measures?

Solutions

1. Macro-prudential supervision must become a central pillar of the supervisory system

In all large financial markets, chiefly in the EU and the U.S., there are plans to appoint systemic risk supervisors. They must have the authority to identify all threats to financial stability, irrespective of their source, and to recommend remedies. A stringent follow-up on these recommendations on an "act or explain" basis must be ensured.

2. The financial system must become less cyclical

Financial systems have always been prone to boom-and-bust cycles. Arguably, this tendency has been aggravated by the transition to a more markets-based financial system. Regulatory changes such as more risk-sensitive capital requirements, fair value accounting and performance-related pay have accentuated this tendency. Changes must be made in these areas as well as in macroeconomic policies, especially monetary policy, to reduce cyclicity.

3. Banks' risk management needs upgrading

Room for improvement exists in almost all areas of risk management. These comprise, to name only the most important ones, the institutional structures for risk management, the methodologies used for risk modelling including the routines for reassessing these methodologies at regular intervals, the vetting of new products, liquidity management, funding structures and risk aspects of compensation practices. Global banks, working together in the Institute of International Finance (IIF), have presented a comprehensive catalogue of measures, which are now being implemented.

4. The regime for capital requirements must be revised

Banks individually and the financial system collectively will need to hold more capital of higher quality in response to pressure from investors, depositors, rating agencies and supervisors. Capital increases should not be across the board, however, but geared to those areas where deficiencies have been revealed. Specifically, this will entail higher capital requirements for securitizations and the trading book. The crisis has also revealed the need for major conceptual changes in the design of capital requirements. In particular, the current VaR-based calculation for trading book assets underestimates risk after a long period of benign market conditions. Finally, measures are needed to make the capital



regime less procyclical. The building of capital buffers in good times, which can then be drawn down in bad times, appears to be one promising option for this.

5. **Liquidity risk requires more attention**

Supervisors as well as market participants have falsely assumed that liquidity in financial markets would always be ensured and available. Higher liquidity reserves and better liquidity management are therefore urgently warranted. New rules must not create trapped pools of liquidity within individual jurisdictions, as this would raise, rather than reduce systemic risk.

6. **Supervision needs to be comprehensive and extend to all systemically relevant market participants and structures**

Over recent decades, many new actors emerged outside of the banking system. These new players provided diversity and helped boost liquidity. But many of them operated not just outside of the banking system, but outside of the regulatory system, as well – and this has now come to be known as the “shadow banking system”. The existence of such a system is not acceptable. Supervisors must have the right to designate institutions as systemically important and subject them to supervision. A risk-based approach should be pursued here.

7. **Stronger market infrastructure to bolster the resilience of the global financial system**

The financial infrastructure must be able to function as a shock absorber, enabling it to withstand the failure of major market participants. The use of central counterparties is one example of how to insulate the financial system from the fallout of failed institutions.

8. **New financial products require an adequate market infrastructure to support a stable market development**

Many market participants in innovative market segments such as securitizations and derivatives lacked the ability to properly price and assess these instruments – which forced them to rely excessively on the judgement of rating agencies. There was also a severe lack of transparency in some of these markets. The markets for these products will only recover if reliable price signals and a robust pricing infrastructure can be established. For this to happen, we need to have a pooling of information on transaction volumes and prices.

9. **Remuneration schemes in the financial sector must be restructured to improve the alignment of individual incentives with the objectives of sustainable profitability and stability**

Compensation schemes are already being reformed. The changes being implemented emphasize a risk-adjusted measurement of performance as well as a longer-term horizon for assessing profitability.

10. **We need mechanisms – at the national and international levels – to deal with the failure of systemically important institutions**

Failure, even of large institutions, must be possible in order to maintain the necessary market discipline. An internationally consistent intervention and resolution scheme must be developed for complex global financial institutions to enable an orderly winding-down of their operations.

11. **Exit strategies**

Central banks must develop strategies to drain money from the system once the recovery is on a firm footing in order to prevent inflationary expectations. The sale of government stakes in financial institutions must be coordinated to avoid competitive distortions.



Dennis J. Snower

President, Kiel Institute for the World Economy; Director, GES

Solvency-convertible bonds and Financial Vigilance Agency (FVA)

Require that the debt issued by systemically relevant financial institutions be “solvency-convertible,” so that if such an institution becomes insolvent, the debt would automatically be converted into equity.

The size of the debt-for-equity swap should be such as to return the institution to solvency and restore its capital adequacy ratio to the minimum required level. What debt is converted and the terms of the conversion would depend on the seniority of the tranches.

This simple measure could ensure that all financial institutions that are “too large to fail” in fact don’t fail. Because as soon as insolvency threatens, enough debt would be converted into equity for solvency to be restored. The institutions may shrink in size, but they couldn’t go under. Through solvency-convertible debt, these institutions would in effect have a solvency guarantee. But unlike the current bailouts, this guarantee would not be financed by the taxpayers, but rather by the stockholders of these institutions. Maximizing shareholder value would then mean avoiding excessive risk. (The bondholders would not be affected, since they would demand a risk-premium that covers their risk of loss through possible debt-for-equity swaps.) This proposal would help prevent the insolvency of systemically relevant financial institutions without requiring tax-financed bailouts.

Establish a Financial Vigilance Agency (FVA) to assess whether new financial products generate systemic risks that the originator does not pay for.

The purpose of the FVA is to assess, detect and prevent adverse economic effects of financial products. These tasks could be conducted in an existing or new establishment. The originators of new financial products would be required to submit the relevant information about expected benefits and adverse side-effects, of new financial products and these products could be launched only with FVA approval. The FVA would collect information about these products, analyze the systemic risks that they may generate, and submit the systemically relevant institutions that offer these products to the relevant stress tests.

The onus of proof concerning the safety of a new financial product would lie with the originator. In these respects, the FVA would serve an analogous function to the American Food and Drug Administration and the European Medicines Agency working with the national competent medicines authorities. In short, the activities of the FVA are meant to ensure that new financial products are not toxic and do not have perverse effects on the economy. With the benefit of this work, the solvency of systemically relevant financial institutions should become straightforward to assess. In this area, this work would effectively replace that of the rating agencies.

Clearly, the practical success of the FVA would depend on its ability to find an appropriate path between the dangers of allowing excessively risky projects and of preventing useful financial innovation. Inevitably, the FVA will make both Type I errors (rejecting new financial products that generate a net gain to society) and Type II errors (accepting new financial products that generate a net loss to society). The important policy decision is to define the rules of the FVA so that the size of each of these errors is minimized and the balance between them is clearly in the public interest.



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There is no doubt that the current global financial crisis is a result of excessive risk taking in financial markets. Banks took much risk and investors were led to buy complex financial products, whose riskiness was not well understood. Existing regulatory and supervisory institutions have failed to keep pace with the growth of financial engineering that lead to complex products. Moreover, credit rating agencies have failed to detect financial excesses that first appeared in the US sub-prime mortgage market in 2007 and later spread to global markets. It was perplexing that many highly rated mortgage bonds plummeted in value precipitating the financial crisis.

Thus it is no wonder that the crisis has triggered calls from all corners for more financial regulation. However, excessive financial regulation has its own downside, namely, by stifling entrepreneurial innovation and reducing efficient risk allocation.

The challenge is therefore to find the right middle ground, where society allows healthy individual risk-taking but makes sure that individual risk does not turn into dangerous systemic risk. The solution should lie on having better regulation, not necessarily more regulation, based on effective supervisory institutions as well as transparency in financial market contracts. The solutions presented below deal with the most pressing issues.

- **Capital requirement for banks.** There is already regulation in place on banks' capital (as in the risk sensitive bank capital proposed under Basel II). However, the existing rules strictly enforce capital requirements, irrespective of economic conditions (the business cycle). This can be counterproductive because it induces bank lending to be pro-cyclical (banks are forced adjust lending in order to maintain their capital base). A solution could be to allow orderly adjustment of bank assets and liabilities when realized losses reduce their equity capital. This solution also prevents fire sales of bank assets, an action that could lead to higher risks of insolvency, especially when many banks try to recapitalize simultaneously. There would still be a role for supervisory intervention before the onset of insolvency and bankruptcy. Finally, capital adequacy ratios should not be based solely on internal bank models, as is the case currently. Judgments about reasonable level of capital should be related in part to market benchmarks (best practices).
- **Strengthening of credit ratings.** Credit ratings are influential in investors' portfolio decisions. Under current practices, a rating agency is paid by the debt issuer, rather than debt buyers, and this raises a possible conflict of interest since the rating agency is typically paid only if the debt is successfully issued. Due to the free rider problem debt buyers have no incentive to monitor the agencies. This means that regulators must ensure proper monitoring of the conflicts of interest inherent in the current rating practice. For instance, supervisory bodies could require rating agencies to give more information about their rating methods. Rating agencies should provide just ratings, not any other products or services, including financial advice.
- **Stock trading.** Short-selling based on economic fundamentals can be useful for correcting overvalued stocks. However, at times short selling may be a destabilizing force by driving down stocks of otherwise healthy companies. One solution is to reinstate rules that regulate short-selling of stocks (such as the up tick rule in the US, which was abolished in 2007). The up tick rule allows short sales only when the last sale price was higher than the previous price. Another solution is disclosure of short selling positions so as to properly uncover possible illegal market manipulation or speculative elements in these transactions.
- **Regulating hedge funds.** The hedge fund industry has become an important player in financial markets, including securities, currencies and derivatives. However, the industry has so far been subject to minor or no regulation. To begin with, therefore, hedge funds



should be registered and disclose regular and timely information about both their asset positions (especially their asset concentration) and leverage levels. Such information is needed to assess systemic risks posed by complex financial transactions. Prudent regulation of banks could also curb any excesses in hedge funds risk taking, as banks usually provide hedge funds subsidized financing through mechanisms such as prime brokerage.

- **Transparency and confidentiality.** The current financial crisis raises the question of transparency and confidentiality in the financial markets regarding different financial institutions. More transparency is needed in terms of explaining what risks are to what extend involved and does the taking of those risks potentially harm the regular – in the sense of basic – banking sector. Here one has to distinguish between the well-established “basic” banking transactions and modern strategies based on financial innovation, which are mostly extremely difficult to understand and difficult to regulate at all. Another approach to establish better transparency would be that banks and other financial corporations report directly to the public instead of to their regulators. The public and the banks themselves could then distinguish between good and bad and banks which are exposed to financial disturbances. Moreover, the onus of transparency would induce managements of financial corporations to behave more cautiously. This leads to another important issue that has to be accounted for, namely the distinction between commercial and the investment banking sector.
- **Commercial vs. investment banking.** One solution to overcome inefficiencies of over-regulation in the banking sector goes back to the Glass-Steagall Act of 1933 which was adopted by President Roosevelt but repealed by the US congress in 1999. The idea is to split commercial and investment banks into a two sector banking system and impose different regulatory laws. A kind of two-tier financial system could be established. Commercial Banks are then restricted to operate in “normal” banking business such as taking bank deposits and issuing loans. These banks would be highly regulated in order to prevent that financial shocks spill over to the normal lending and deposit business of the real economy. Investment banks would have the freedom to take more risk and conduct trading relatively free of regulation. The solution would allow commercial banks to continue to underwrite securities and provide merger advice, activities historically handed by investment banks.

Axel Weber

President, Central Bank of Germany

The root of the current global financial crisis has been excessive risk-taking. A significant underpricing of risk and rising financial leverage made the financial system vulnerable. A general loss of confidence ultimately led to its collapse. The factors that contributed to the global financial crisis are manifold, ranging from microeconomic aspects – in particular, skewed incentives, regulatory weaknesses and an underestimation of risk – to macroeconomic aspects, such as global current account imbalances and a blind belief in the persistence of the “Goldilocks economy.”

Initiating reforms now

To balance risk-taking and, thus, to enhance the financial system’s resilience it is vital to tackle all of these issues. Strengthening financial regulation will cover many of them and, consequently, is usually found at the top of the international agenda. It goes without saying that even the most cleverly designed regulation cannot prevent short spells of financial instability. In globalised financial markets, where financial innovation is, in principle, to be welcomed because it brings economic progress, occasional excesses are bound to happen. However, reforms can considerably improve the resilience of the global financial system. Such reforms have to be initiated now that awareness of the immense costs of financial instability



has created a window of opportunity for a redesign of the global financial architecture. That window will not remain open for ever.

Safeguarding a level playing field

The starting point for a comprehensive financial stability framework is to safeguard a level playing field. Therefore, in April 2009, the G20 agreed to extend regulation and oversight to all systemically important financial institutions, instruments and markets. The objective must be to find and close regulatory loopholes such as those exploited by the shadow banking system. Hedge funds are a case in point. Although they have not been at the centre of the financial turmoil, they have been greatly affected by the crisis. The rapid unwinding of their highly leveraged positions tended to exacerbate the turbulence and, hence, posed an indirect risk to the financial system. Therefore, hedge funds should be registered at the international level and hedge funds whose transactions might have implications for systemic stability should, in addition, be subject to direct supervision.

Reforming banking supervision

In spite of an ongoing worldwide trend towards disintermediation, the financial crisis has also shown that banks remain the primary link between the financial system and the real economy. It is therefore essential to further improve banks' risk management and to review their capital and liquidity requirements. Banks' own resources have to return to being an effective first line of defence against financial pressures. Furthermore, in the course of the financial crisis, banking supervisors have been stepping up international coordination and cooperation. This is particularly true of Europe, not least owing to the ongoing integration of euro-area financial markets. Nonetheless, we have to keep in mind that supervisory competence and responsibility lie, for the time being, with the national authorities. Cross-border cooperation should evolve in line with market developments, not run ahead of it.

Strengthening market discipline

Even though it is key to reform financial regulation and make it more proactive, market discipline has to be strengthened as well. Of course, financial markets cannot be trusted to regulate themselves, but improved disclosure requirements concerning banks' exposures, risk profiles and valuation approaches will still help to improve risk assessment among financial market participants. In the short run, this will also help to rebuild confidence. In addition, readjusting incentives for market participants, financial sector employees and credit rating agencies is vital. Above all, once the crisis is over, governments must find ways of dissuading markets from relying too strongly on banks being too big or too interconnected to fail.

Guarding against systemic risk

However, important all of these measures are, supervision has to be taken one step further if we want to address fully the causes of the current financial crisis. The entire financial system is more than the sum of its parts. Therefore, it is not sufficient to safeguard the stability of each individual bank; instead, systemic risk has to be identified and guarded against. There are numerous issues to be addressed: How to restrain the build-up of risk taking during boom periods? How to reconcile the risk-sensitive approach of Basel II with the pro-cyclicality of lending? How to prevent a renewed build-up of global current account imbalances? Central banks are at the forefront of financial stability analysis. They take a strong and natural interest in it because of the interdependence between monetary policy and the financial system. Moreover, as the majority of central banks, at least in the euro area, have supervisory responsibilities or are strongly involved in banking supervision, generating information-related synergies between supervision and monetary policy as well as deploying central banks' technical expertise will surely contribute to promoting financial stability.