CENTER FOR FINANCIAL STUDIES

WHITE PAPER
NO. VI

OCTOBER 2010

Recommendations by the Issing Commission -Memo for the G-20 November 2010 Summit in Seoul-

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PART I SUMMARY OF RECOMMENDATIONS

1. We see four key policy measures necessary to achieve a more resilient and stable financial system
   - De-risking individual financial institutions (increasing capital requirements under Basle III);
   - Imposing bail-in (as opposed to bail-out) for debt and equity holders;
   - De-risking the financial system by limiting the extent of systemic risk (creating a systemic risk charge together with an oversight body)
   - De-risking the trading of securities and derivatives, by requiring financial institutions to use central counterparties (CCP) in these markets.
2. While progress on all four accounts is impressive, more needs to be done.
   - Basle III has to be implemented in lockstep, and in all G20 countries.
   - Bail- in procedures have to be coordinated cross-border, and appropriate measures are (still) needed to assure a certain fraction of each bank's debt to remain truly defaultable. That is, some bank debt (bonds in particular) have to be permanently held outside the core financial sector, by holders not subject to any deposit insurance scheme.
   - To allow systemic risk monitoring, data sharing arrangements between jurisdictions need to be formally agreed on, and a formal mandate has to be given to some agency in order to progress towards data consolidation and systemic risk assessment.
   - All derivatives trades have to be cleared (or at least reported) via central clearing institutions, of which there should exist but a very few.
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3. The proposal for a Global Financial Safety Net (GFSN) addresses the important issue of liquidity reserves and self-insurance against external shocks.
   - The accumulation of currency reserves is seen as a by-product of the exchange rate policy, not as the result of self-insurance.
   - An institutionalized scheme for additional liquidity provisioning may enhance moral hazard and has other shortcomings.
   - Alternative sources of liquidity, like the provision of trade finance, would appear more favourable.

PART II REMAINING ISSUES RELATING TO SYSTEMIC RISK DETERRENCE (A-D)

INTRODUCTION

This is the fifth G-20 preparatory report written by this very committee since 2008, before the first G20 meeting in Washington. For almost everybody involved in the crisis 2007-2010, the systemic dimension of national and international financial markets had not been on the radar screen of possible risks. Not surprisingly, the systemic dimension of bank risk was not taken care of by regulators or by risk managers. In the parlance of economics, systemic risk is an externality, that is: a risk factor which is not properly considered in the decision making of bankers around the globe. As with any negative externality, the unregulated market will produce an excessive amount of it. If governments have not used some form of regulation to ensure the banks pay the costs of these externalities, they will be forced in the end to step in and to bail out the vital parts of the financial system[1].

Without a proper internalization of systemic risk, the state (and the taxpayer) unavoidably will remain the hostage of the banking sector. What is needed to internalize systemic risk?

Looking at the current state of the regulatory reform process, we see a lot of the issues raised in our reports of the years 2008 and 2009 to be currently in the implementation phase. Looking ahead it will be important to focus on those issues that are essential to limit systemic risks. Issues, like hedge fund oversight, management compensation, rating agency supervision, non-complying jurisdictions and some forms of transaction levies should not distract from tackling the key challenges. The international dimension has to be added to the list of key challenges. Among them figures prominently the proposal of a global financial safety net (GFSN). This proposal will be taken up in section E, below. The preceding sections A-D review the main regulatory changes currently under way, and point out some loose ends, requiring clarification at the G20 meeting in Seoul. They are: capital adequacy (Basle III), crisis intervention (bank bail-ins), crisis prevention (systemic risk charge), and central clearing of derivatives.

In our view, there are **four key policy measures to achieve a more resilient and stable financial system**:

A. De-risking individual financial institutions (increasing capital requirements under Basle III);

B. Imposing bail-in (as opposed to bail-out) for debt and equity holders.

C. De-risking the financial system by limiting the extent of systemic risk (creating a systemic risk charge together with an oversight body)

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[1] One may ask why systemic risk became such an enormous problem in the early 2000ies, rather than during the eighties, say. The reason for the rise in systemic risk can be found in the surge of derivatives and other new instruments in financial markets, like CDOs , CDS as well as international asset management strategies, which have resulted in highly interconnected global financial markets and institutions. As well, banks found ways to reduce their capital (and increase leverage) even as systemic risk was rising.

D. De-risking the trading of securities and derivatives, by requiring financial institutions to use central counterparties (CCP) in these markets;

We think that on all four accounts, impressive progress has been achieved to date, or is in an advanced preparatory stage. However, the effort by governments to get the necessary legislation enacted must not fade. Without full implementation of regulatory changes on all four accounts, the self-stabilizing capability of the financial system will be deficient.

A. De-risking individual financial institutions (Basle III)

- No comments from our side, except that synchronous implementation in all major jurisdictions, including US, UK and Europe is very important – but seems to be ascertained by now.

B. Imposing bail-in (as opposed to bail-out) for debt and equity holders

a. A credible threat to all banks that their debt holders and equity holders will suffer before the tax payer will bail them out is now more widely accepted as a key regulatory challenge than ever before (too big to fail). We have advocated a **stringent resolution regime for large and complex financial** institutions in an earlier report, submitted just before the Pittsburgh meeting. Legislation empowering supervisors to create Good Banks comprising the systemically relevant parts of a troubled financial institution, and enabling the remaining Old Bank to bail-in their creditors and owners is now under way in some countries, among them most recently Germany ("Restrukturierungsgesetz"). These national legislative efforts need to be complemented by two activities, both of which should be addressed during the G20 meeting in Seoul. These activities aim at cross-border coordination of bail-in activities.

b. As of now, the US is relying on insolvency of failing institutions, whereas Europe wants to use Cocos and other bail-in procedures to keep firms at least partially alive as a "going concern". This is an important obstacle since it implies that, for internationally active big firms (i.e all large and complex financial institutions) there is still no agreed way on how to proceed. Therefore, the first coordination issue relates to an "**international legal overlay**", preparing the ground for cross-border financial failures. There is currently no sound procedure for dealing with cross-border bank failures – however, it seems to be self-understood that large and complex financial institutions are likely to be at the forefront of any future systemic financial crisis. For this reason we advocate strongly the initiation at the G20 level of a consultative process developing a "legal overlay" that consistently connects national legislations as well as national supervisory authorities for the case of

cross-border failures. Both the agenda as well as the time line should be fixed during the Seoul meeting.

c. The second coordination issue relates to a key requirement for any credible borrower bail-in procedure[2], namely the existence of some bank creditors that are able to take a haircut (i.e. a loss) during a debt restructuring without causing further contagion within the financial system. The **necessity of having true risk takers among each bank's lenders** has not been sufficiently emphasized in the past, and therefore has not been included in any national legislation to date. However, without a regulation on defaultable bank debt which must be held outside the core financial system, the current bail-in procedures can easily be avoided by the banking industry – and we have reason to believe that this will actually happen in times of systemic stress[3].

d. Note that the 'systemization' of bank debt, resulting from the identity of the holder as another bank, has to be prevented on an international level too. For this reason, a **common approach on the G20 level** is recommended, aiming to ensure that a minimum level of bank debt remains truly defaultable at any time[4]. On a practical level, in order to render a separation of the Good Bank from the Old Bank feasible, LCFI should prepare in advance the necessary information[5].

C. De-risking the financial system by limiting the extent of systemic risk

a. This is in our opinion the single most important point on the Seoul agenda. Currently, there is no consensus on whether **a systemic risk charge should be levied**, and how it could possibly be measured. Concerning the risk charge, its amount should be sensitive to factors that have an impact on overall systemic risk, and which are under the control of the individual bank and their management[6]. Thereby bank management is induced to develop its

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[2] Bank equity holder bail-in is not addressed here, because they have proven to work fairly well during the past few years. This, however, is not true for debt holders who typically were fully bailed-out by tax payers money.

[3] Note that the requirement to issue defaultable debt held outside the core-financial system should not be confounded with the requirement to issue subordinate debt. This latter proposal is out in the literature for a long time (Charles Calomiris (1999), "Building an incentive compatible safety net", Journal of Banking and Finance 23, 1499-1519.). This is not what we propose. Our point relates to the fact that even subordinate debt will become systemic, and hence will be bailed-out if, in times of systemic stress, it is transferred into the hands of another financial institution.

[4] Details of such an agreement will comprise, e.g., a minimum share of bank debt outstanding to be held outside the banking system. Banks and other institutions in the core financial system are not allowed to invest in these securities. Note that qualifying investors, like pension funds and life insurance companies, in turn, must be entitled to hold "truly defaultable bank debt", even if its rating deteriorates below investment grade.

[5] This may be achieved by a living will, as proposed by contingency plans produced by the bank itself, or by its auditors, and shared with the supervisor.

[6] See our report for the Toronto G20 meeting (Issing/Krahnen/Regling/White, June 2010), "Criteria for a workable approach towards bank levies and bank restructuring", which develops a model for a systemic risk charge levied upon banks. The receipt is immediately reinvested into the bank in the form of a coco bond (contingent convertible), held by the government. Thus, no liquidity actually leaves the bank (there is no reduction in its capacity to lend), while the government retains the possibility to raise its revenues (through a sale of the bonds to the public). The trigger right, i.e. the option to swap the debt into equity

business model and its organizational form such that its systemic risk contribution is reduced[7].

b. We advocate three ingredients to an effective policy towards systemic risk containment: data sharing between jurisdictions, supra-national risk assessment, and a clear mandate to an international agency. All ingredients should support the definition of an appropriate systemic risk charge.

    i. Data sharing between jurisdictions. This brings us back to the concept of a Risk Map, a unified model of financial system risk data collection. Despite some data collection activities on the level of national central banks and the ECB, not much has happened to date to prepare the sharing of information between national authorities. A clear **commitment on the G20** level in favour of such a **comprehensive data sharing agreement** would not only be highly valuable, it is actually a sine-qua-non for any serious progress on the systemic risk front.

    ii. Supra-national risk assessment. The data required to carry out a meaningful systemic risk analysis are, given that they contain bank-specific information on bilateral exposures and portfolio structures, highly sensitive and potentially very relevant for market competition. A very high standard of confidentiality protection is therefore a prerequisite to win over a majority of interest groups in each country, and a majority of countries, too. While we think that the national level is too low a level to get the job done, the global level may be unrealistically high. Thus a regional approach, like a European or an American risk map data project may suffice to achieve a satisfactory level of systemic risk transparency. G20, therefore, should ensure that such **regional systemic risk data hubs** do in fact get off the ground.

    iii. Our final point for the Seoul agenda, related to systemic risk, is the issue of policy mandate. Even if the technical prerequisites for systemic risk monitoring are in place, it remains unclear what actions a national supervisor will take, once systemic risk reaches alarmingly high levels. Regulatory forbearance is a likely result here. It seems therefore important to take out the competitive element in systemic risk measures, by locating not only the analytical capacities and the eventual judgement **to a supra-national authority** (in the case of Europe, this will be the ESRB at the ECB), but also the decision on its implementation.

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remains with the government, or is delegated to the European Systemic Risk Board. If triggered during a financial crisis, interest bearing debt is converted into (non-interest bearing) equity, thereby strengthening the bank's capital position and lowering its direct funding costs.

[7] Examples of factors under management control that are likely to have an impact on systemic risk are: its involvement in the derivatives markets, the tier-structure of the organizational model (one- tier versus two-tier), the extent to which a bank is integrated into a net of claims and liabilities among peer banks.

D. De-risking the trading of securities and derivatives.

a. For both the US and Europe, the rules for centralized clearing via more standardized products and central counter parties (CCP) is well under way. There is also wide-reaching agreement between the US and the European regulatory approach. What still needs to be clarified (and harmonized) is the basic **incentive of participants to actually use the CCP**. Otherwise, in some markets, there may even be an increase of OTC activity rather than a rush to product standardization.

b. Regulatory efforts should be made to require *all* derivatives transactions to be centrally cleared or, if there are reasons not to request clearing, at least all derivatives transactions must be reported to a central clearing house. A high enough capital charge under Basle III for non-centrally cleared positions, together with a small-enough number of clearing houses[8] will provide strong incentives to market participants to clear via a central counterparty. With most or all volume of derivatives centrally cleared, the potential contagion risk within a financial system is considerably reduced, and at the same time there is significantly higher market and position transparency for supervisors. This would greatly facilitate carrying out sophisticated stress tests for the banking system[9].

PART III GLOBAL FINANCIAL SAFETY NET (GFSN)

E. Global Financial Safety Net (GFSN)

a. It is **positive** that the proposal

- wants to draw lessons from the crisis,
- sees the first line of defense to reduce the vulnerability of countries to external shocks in sound economic and prudential policies, and
- wants to reduce countries' preference for self-insurance through large scale foreign exchange intervention and reserve accumulation.

These positions should be uncontroversial and find general support. However, other aspects of the proposal need to be critically assessed.

b. The role of currency reserves

[8] The number of clearing houses covering the world market needs to be small. Otherwise there may be no netting advantage for users, i.e. they may be required to post even more collateral than they would under the OTC regime (see Duffie/Zhu, "Does a central clearing counterparty reduce counterparty risk?", Rock Center of Corporate Governance, Stanford University 2009.)

[9] Some users, like airline companies, currently request an exemption from margin requirements because they do not have to post any collateral in forward contracts with their suppliers (e.g. oil companies). One can imagine allowing zero-margin trades to be recorded via the CCP, in order to have full information about position taking at the supervisory level, see John Hull (July 2010), "OTC derivatives and central clearing: can all transactions be cleared?", Banque de France, Financial Stability review 14, pp. 71-80.

To our judgement major countries like China, Taiwan, Singapore, Hong Kong and oil producers in the Middle East do not run large current account surpluses as a way to self-insure themselves. Rather, these countries are intervening to hold down their currencies in order to promote exports (Asia) or for other geopolitical reasons (Middle East). Thus, the fact that they have accumulated a large amount of reserves does not imply that they feel they "need" such reserves as insurance. Rather, the level of their reserves is a simple by-product of their exchange rate policy. From this it follows logically that, if they do not feel they "need" such reserves, there is no "need" to find alternative sources of liquidity to replace such reserves. **In sum, the link between global imbalances and a GFSN seems far-fetched.** The present document now admits that the "availability of global FSNs will not … have an impact on reserve accumulation for non-precautionary reasons", thus removing one reason for establishing GFSNs.

c. Need for extra liquidity support?

This leaves open the question of whether a number of other countries that do not have large foreign exchange reserves, and which benefited during the crisis from Fed swaps (like Korea) or the IMF's Flexible Credit Line (Poland, Mexico), might still need an institutionalised scheme for additional liquidity provisioning. Here, we would raise three sets of concerns. They have to do with (a) identifying the need for extra liquidity support, (b) the alternatives which are already available, and, (c) important practical problems associated with some of the specific plans proposed.

i) Perhaps there **could be a need** at certain times for more easily available foreign currency to meet a capital outflow due to circumstances beyond the control of the country in question. Nevertheless, we see problems with institutionalising the approach developed during the crisis:

- Most important, <u>moral hazard</u> for creditors and debtors would increase. Among the various forms of inappropriate behaviour that might be encouraged would be still more resistance to exchange rate appreciation. Such resistance, either through reserve accumulation or easier domestic monetary policy, makes a crisis more likely. The document mentions the need to address the moral hazard problem through conditionality and private sector involvement but remains vague on implementation. The risk of moral hazard is treated very unsatisfactorily – to say the least. On the one hand the paper stresses the importance of "strong ex-ante qualification criteria" to limit moral hazard. On the other hand, a "high degree of discretion" is considered and "sharp qualification boundaries" might not be applied. An appropriate regime for dealing with the moral hazard problem cannot be based on such contradicting proposals.
- It is impossible to distinguish between a "liquidity shock" and a "solvency shock" as the proposal tries to do.

- The global crisis of the last two years is unlikely to be repeated soon.

ii) In any case, **alternative sources** of liquidity support are much more available now than before the crisis:

- IMF resources have tripled.
- Regional support mechanisms have been created (EFSF for the euro area) or improved (Chiang Mai for ASEAN+3).
- Central banks gained experience with ad-hoc solutions in a real crisis and can use that experience.
- Basel 3 is working on liquidity buffers for banks and recognizes the possibility of foreign exchange exposures.

iii) Certain **problems** can be identified with the various proposals put forward, not least the proposal for an FX Liquidity Insurance scheme (FLI). The scheme proposes that countries with sound fundamentals would "prequalify" and be given automatic access to the facility when in need. Eligible countries would pay a premium in normal times. Funding would come from some combination of premia, central bank credit lines and SDRs. In this regards we see the following problems:

- Pricing insurance in the face of uncertain (as opposed to risky) events will be very difficult.
- Requiring central banks to provide liquidity at the request of the IMF (dominated by Treasuries and particularly the US) could well pose difficulties
- Relying on an expansion of the use of SDRs and abolishing any access limit for IMF resources raises numerous concerns. If the IMF is asked to act more like a global central bank, does it have a governance structure which is appropriate for such a role?

iv) In the face of all these concerns, the following approaches could still be **useful**:

- Consider ways for quick-disbursing trade finance if and when export receipts collapse (resurrect the Fund's Compensatory Financing Facility?).
- Make sure that global and regional support mechanisms, including swap agreements between central banks, are consistent and compatible.