Preparatory comments for the G-20 meeting in Pittsburgh

(to be held on September 24, 2009)

by

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A Preface

In our two reports of 15 November and 2 February we identified the main elements of a New Financial Order. These considerations are still relevant. In this report we present some concise reflections on issues which are, or should be, on the agenda of the next G-20 meeting.

B Comments on existing proposals, missing hot topics, and prioritization

B. 1 Short comments on the preparatory document[1] issued by the host

1) All the suggestions (summarized in 7 priorities on page 3 and 4 of this document) seem generally worthy of pursuit, especially those directed at mitigating systemic risk.

2) Setting specific deadlines for the implementation of proposals is clearly desirable. The timeline should be explicit, realistic, and monitored. In this regard, further specifications may be helpful; e.g. mandating the IMF to monitor progress and to report mid-year 2010. However, the deadlines should not be so tight that they preclude adequate reflection about what needs to be done. For example, the choice of a leverage ratio to complement Basel II and the definition of capital both pose difficult analytical problems. An end year deadline seems problematic.

3) There are a number of important topics missing from the list of proposed issues:

- What steps should be taken to insure that all financial institutions, even large, internationally active ones, can be wound down in an orderly way. This issue is addressed by us in section C, below.

- It should be recognised that steps taken to support the financial system in the short-run might make future problems worse. In addition to the moral hazard problem, many financial institutions are now bigger and more complex than before the crisis.

- To implement properly many of the proposals suggested we need not only to collect more data, but also to allow sharing them between supervisory agencies; we emphasize here the risk map-concept presented earlier. Currently, there are fundamental

[1] G-20 Financial Regulatory Reform Priorities for Pittsburgh

legal and other impediments to the collection and use of data that should be removed quickly and in a concerted way (at a minimum, within Europe). Addressing this issue in Pittsburgh is crucial if one wants to go forward with macro-prudential supervision.

- No attention is paid to the possibility that a discretionary oversight of financial institutions might not be effective. In the last credit upswing every level of governance failed. This raises the important issues of rules versus discretion.

B.2 SHORT COMMENTS ON G-20 ISSUES PROPOSED BY THE GERMAN AUTHORITIES

1) "All firms/markets/instruments should be appropriately regulated"

The principle is fine. However, we must be careful not to suggest that unregulated entities were responsible for the crisis. In fact, much of the damage was done by large, regulated institutions and off-balance sheet entities set up by such institutions for regulatory arbitrage. At a minimum, one wants to find agreement that all firms/markets/instruments are part of the risk map project, i.e. are covered data-wise. Note that even this moderate request seems to be off the agenda. As noted above "all" levels of governance failed.

2) "Implementation of earlier commitments (level-playing field)"

There is a risk that the implementation of earlier agreements will proceed at different paces in different countries. This poses the threat of some countries gaining temporary competitive advantage. This is particular relevant in the following areas: capital requirements, provisioning, leverage ratios, compensation and accounting rules. As emphasized earlier (when discussing the US proposal) we suggest having an explicit, realistic, monitored and sanctioned (praise-or-blame) time line for implementation, involving an international body (BIS, FSB).

3) Compensation

Compensation schemes should be adapted along the lines of the FSB principles to make them less short-term oriented. However, it must be recognised that the problem of shorttermism in financial markets is deep-seated and cannot be explained solely on the basis of compensation schemes. In good times there is a natural tendency to extrapolate a continuation and to discount associated risks. Moreover, financial market participants who do not play this extrapolative game, and underperform for an extended period of time will lose their jobs.

4) Exit strategy

Everybody agrees that the emergency measures introduced during the crisis in the areas of fiscal and monetary policy, bank guarantees, state aid, etc. must be reversed once the crisis is over. Timing will be the contentious and controversial issue. When will economic activity reach a "normal" or "sustainable" level again?

The problem is that the "new normality" after the crisis will imply growth rates substantially below average growth rates before the crisis. Trend growth for the next 10 years will be below trend growth until 2008. Potential growth always falls after an economic downturn because certain capital becomes obsolete, there is less investment and structural unemployment rises. In addition, after this particular global financial and economic crisis, potential growth will fall for a number of important reasons:

- Bubbles in the financial and housing industry pushed up growth before the crisis; this will not and should not be repeated.

- Rapid trade opening added to growth before the crisis, but this will not be repeated. Indeed, it could even be reversed to some extent if protectionist measures become widespread.

- Anti-competitive measures as part of unavoidable crisis management will lead to less competition in the economy (particularly in the US and Europe). Less competition means less productivity growth and less potential growth.

- The public sector and regulation are very likely to grow during the next few years. Moreover, tax rates will go up to pay for the crisis. Both of these trends will reduce potential growth.

- For many countries the demographics of aging and the impact of climate change and change mitigation will also reduce trend growth.

Consequently, growth rates could be disappointingly low. Given that both policy-makers and the public will remember the growth rates recorded in the recent past as being "normal" they will not accept easily that the emergency measures recently taken in the fiscal and monetary policy areas should be reversed.

The same conclusion can be reached by looking at output gaps. For the reasons mentioned above, it is very likely that the positive output gap estimated before 2008 was substantially larger than estimated so far. By the same logic, the negative output gaps to which many commentators refer could actually be much smaller. An over-estimation of output gaps happened, for example, in the US in the second half of the 70's and resulted in serious policy mistakes with a resulting rise in inflation.

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C Too big to fail and resolution regimes for Systemically relevant Banks

C.1 Too big to fail? A fundamental challenge

The financial crisis has severely damaged trust not only in the financial system, but in the free market economy as such. A repetition of a crisis of comparable dimensions in the not so distant future might support the case of extremist parties.

A major factor in this context are government interventions which have been needed on the one hand, to save the system from a meltdown, but have on the other hand led to the impression that systemically relevant financial institutions will have to be bailed out also in the future, thereby "socialising" losses while profits remain in private hands. This is the issue of "too big to fail".

An efficient market system encourages entrepreneurs to take risks by promising rewards, but this also implies accepting losses caused by bad decisions. If the sanctions provided by potential losses and eventual bankruptcy are removed, or are not credible, then moral hazard is the consequence. That is, bankers will, in the future, be still more inclined to gamble with other people's money. There is no justification for keeping profits in private hands and putting the burden of losses on society, i.e. the tax payers.

Therefore, the challenge stemming from government response to the crisis is how to establish a credible framework to ensure that the "too big to fail" problem will not arise in the future. It is obvious that this will be neither easy nor possible without clear, binding rules which will be perceived as painful from the perspective of some individual players. Considering the dimension of the problem which has severely increased because of the rescue measures taken and the ongoing concentration in the financial industry, it is more than surprising that, for an extended period, authorities did not really seem to care.

In the meantime several proposals are presented to deal with this problem.

1) A direct approach would put quantitative limits on size and activities of individual financial institutions. But, it is obvious that it would be very difficult to apply this principle in a reasonable way.

Relying on the "narrow bank" idea" also does not seem a convincing proposal .It would solve the "bank run problem", especially if reinforced by some form of deposit insurance, but would leave all risky activities to the rest of the financial system.

2) More convincing is the proposal to impose strict capital and liquidity regulations on systematically relevant financial institutions. An elegant way would be to increase those requirements gradually with the growing size of relevant institutions. However, given the importance of derivative products for banks, it becomes increasingly difficult to measure with some degree of precision the "size" of any financial institution

3) For this reason, other proposals go in the direction of making those institutions easier to close, thereby avoiding risks for the whole system. In this spirit banks are required to prepare a "shelf-bankruptcy" plan. We discuss ways to close down large banks below.

These measures are not exclusive. Obviously, proposals 2) and 3) could and should be combined elements for a better system.

The case of "too connected to fail" refers to the fact that e. g. the collapse of any highly leveraged financial institutions could be disastrous to a huge number of other players, thereby creating risks for the whole system. The solution to this problem might be the creation of a kind of two-tier financial system with highly regulated institutions with limited activities and a kind of implicit state guarantee and no exposure to those institutions which are licensed to take higher risks an credibly “earmarked” for not being bailed out. Moving OTC derivatives to centralised exchanges would also help to reduce excessive interconnection.

It is obvious that designing consistent rules and then implementing them is a tremendous challenge. It is easy to mention all the obstacles not least coming from the aspect of a global even level playing field. However, to capitulate to this challenge or just ignoring it would imply laying the fundament for the next systemic crisis. This is just not acceptable.

C.2 RESOLUTION REGIMES FOR SYSTEMICALLY RELEVANT BANKS

In a nutshell, the challenge of any reasonable resolution regime for systemically important banks can be defined as follows: how to provide a mechanism that allows banks, even large, complex and internationally interconnected institutions to fail, while simultaneously avoiding a systemic credit event. In other words, the challenge for policy makers is to design a resolution regime that is at the same time *forgiving* with respect to systemically important , already established interconnections between financial institutions and *unforgiving* to the very institution’s financiers.

The required solution, therefore, has to combine an unconditional state guarantee for the bank’s new businesses, initiated after the resolution onset, with an orderly rundown of its old businesses, contracted before the resolution date. The former effectively acquires a senior claim over the earlier business transactions. As an illustration, one could think of creating a resolution scheme that resembles a banking hospital. The hospital will be set up by the state to take over the treasury management of the troubled bank at short notice. An ‘over-the-weekend bailout-drama’, as was recently experienced in Germany (e.g. IKB. HRE) and elsewhere (Bear Stearns, Northern Rock), will be substituted by an orderly wind-down of the institution, accompanied by a capital restructuring. The hospital will thus support the financial blood stream of the bank, with liquidity assistance if required, while at the same time allocating losses to capital according to seniority.

As a result, realized asset value losses will be borne first by equity. If equity is not sufficient to cover losses, junior debt will incur losses, then senior debt and deposits, and only lastly will taxpayer money be affected. Thus junior claims, like hybrid capital, will be wiped out entirely before more senior claims are hit. The resolution code will have to specify, among other things, that and how debt is converted into equity, once the latter is wiped out. In other words, the swapping of debt into equity has to be predefined in the resolution code.

The reasons for adopting such a resolution regime, using state money only intermittently, is to minimize the risk of bailout by taxpayer's money, thereby diminishing moral hazard. By fighting the abuse of bail-out policies (socializing losses, while privatizing profits) a resolution regime should be at the heart of any long-term strategy for stabilizing financial markets.

There are a number of subtle economic and legal issues that warrant further elaboration:

- It has to be well defined in advance under what material conditions a troubled bank can be assigned to the hospital by the supervisory agency.
- Equally, it has to be analyzed how derivative positions, and dynamic option strategies can be embedded in the concept of 'old' and 'new' businesses.
- Our proposal envisages a transitory role for the government as is the case in the proposals currently circulated by the two Ministries in Germany.
- Pushing for a uniform resolution scheme among G-20 member states will probably generate positive ex-ante effects in banking markets, as the cost of equity financing, relative to debt financing, is likely to fall for large interconnected banks.