

Eichengreen, Barry et al.

## Conference Paper

# Tackling systemic financial risk

Session Handouts, Global Economic Symposium 2008 (GES), 4-5 September 2008, Plön Castle, Schleswig-Holstein, Germany

### Provided in Cooperation with:

Kiel Institute for the World Economy – Leibniz Center for Research on Global Economic Challenges

*Suggested Citation:* Eichengreen, Barry et al. (2008) : Tackling systemic financial risk, Session Handouts, Global Economic Symposium 2008 (GES), 4-5 September 2008, Plön Castle, Schleswig-Holstein, Germany, Kiel Institute for the World Economy (IfW), Kiel

This Version is available at:

<https://hdl.handle.net/10419/79087>

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## Security: Creating a Safer World

# Tackling Systemic Financial Risk

### Summary

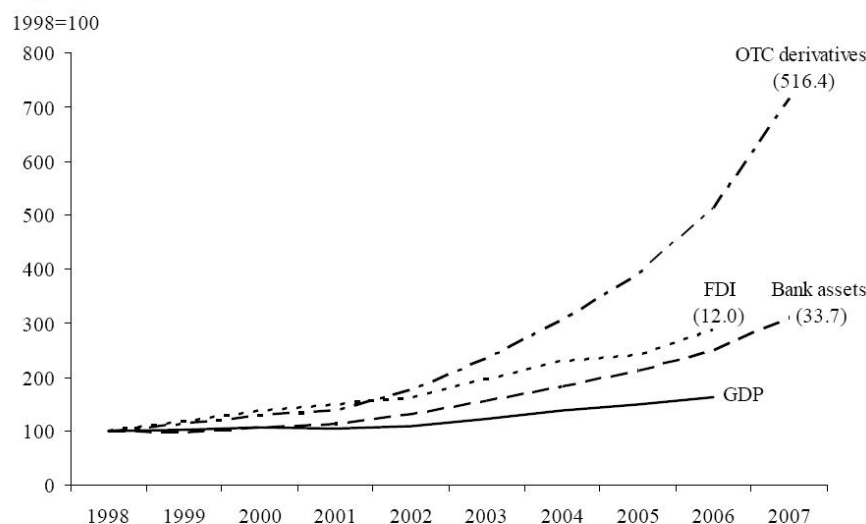
Financial globalization helps individual market participants diversify risk, but need not stabilize the international financial system as a whole. Given increasingly complex financial innovations and interrelated markets, a shock in one particular market segment may trigger serious contagion in other segments.

Recently, the U.S. housing market decline and the subprime meltdown led to a proliferation of financial risks in other financial markets and sectors worldwide. What policies are required to deal with the problem that the diversification of credit risk reduces the incentive of creditors to scrutinize borrowers? Is it sufficient to rely on voluntary codes of conduct by hedge funds, or should they be regulated either directly or indirectly?

Which kind of regulatory and supervisory approaches (rules versus discretion) are most promising? What are the appropriate strategies for fighting a major financial cross-border crisis effectively, once crisis prevention has failed or reached its limits?



### Slightly Out of Touch?



Notes:

Figures in brackets = US\$ trillion in final year;

GDP = world GDP, US\$ in current prices;

FDI = worldwide stocks of inward foreign direct investment, US\$ in current prices;

Bank assets = total assets of BIS reporting banks, international positions, amounts outstanding, June, US\$;

OTC derivatives = over-the-counter derivatives, notional amounts outstanding, total contracts, June, US\$.

Sources: BIS; UNCTAD; World Bank



## **Proposed Solutions**

### **Expert Opinion**

Financial globalization helps individual market participants diversify risk, but need not stabilize the international financial system as a whole. Given increasingly complex financial innovations and interrelated markets, a shock in one particular market segment may trigger serious contagion in other segments. Recently, the U.S. housing market decline and the subprime meltdown led to a proliferation of financial risks in other financial markets and sectors worldwide. What policies are required to deal with the problem that the diversification of credit risk reduces the incentive of creditors to scrutinize borrowers? Is it sufficient to rely on voluntary codes of conduct by hedge funds, or should they be regulated either directly or indirectly? Which kind of regulatory and supervisory approaches (rules versus discretion) are most promising? What are the appropriate strategies for fighting a major financial cross-border crisis effectively, once crisis prevention has failed or reached its limits?

### ***Transparency and Accountability***

Enhanced disclosure by financial intermediaries about risk exposure, valuations, off-balance sheet entities and the like can help restore market confidence in times of crisis. Transparency is required at each stage of the securitization chain, e.g., through standardized information flows. Senior management shall be held responsible for developing an appropriate infrastructure concerning the reporting and prompt settlement of over-the-counter derivatives. Substantial efforts of financial institutions are required to improve liquidity risk management practices. Refined stress tests and improved contingency plans shall ensure that institutions build sufficiently large liquidity buffers.

### ***Conflicts of Interest, Risk Illusion, and Pro-Cyclicality***

Revised codes of conduct may help reduce conflicts of interest of credit rating agencies. It is debatable, however, whether voluntary rules of conduct will do the trick. Regulatory authorities may wish to re-assess the role assigned to credit rating agencies, in order to prevent uncritical reliance on ratings as a substitute for independent evaluation and to contain the pro-cyclical behavior of financial institutions. Given that risk tends to return to the banking industry under conditions of stress, the incentives to transfer risks to off-balance sheet conduits for the purpose of reducing regulatory capital charges need to be addressed during normal times. Under conditions of crisis, the challenge is to prevent disruptive dynamics such as fire sales of impaired assets. This requires a review of “fair value triggers”, in the direction of allowing for more flexibility to prevent financial intermediation spiraling downwards.

### ***Oversight and Regulation***

Financial market regulators need to catch up with global financial market development and innovation. In particular, a prudential framework for the regulation of off-balance sheet activities has to be developed. Capital requirements for risky and complex credit exposures have to be reviewed and, probably, raised. Regulators must be provided with sufficient legal power and resources, and may have to play a more active role in reviewing the liquidity management of financial institutions. At the same time, a regulatory overkill must be avoided in order not to stifle financial innovations.



## ***Moral Hazard and Systemic Risk***

Tougher supervision and tighter capital standards are the price the financial industry has to pay for bail-outs having become ever more likely to stem systemic risk. Yet central banks should re-assess their role in inflating speculative bubbles and relaxing credit discipline, as well as design ways to make their actions during stress less predictable. This is especially because the classical distinction between (global) illiquidity and insolvency (of highly leveraged institutions) is increasingly blurred, considering that fragile balance sheets of large institutions involve systemic risk due to unorderly unwinding of exposures.

## **Strategy Perspectives**

### ***GES Solutions***

Barry Eichengreen

*Professor of Economics and Political Science, University of California, Berkeley*

The recent financial crisis is a complex event, but some of its lessons are simple. This summary of the lessons as I see them draws on my “Thoughts on the Subprime Crisis” (see the background readings).

First, there is no optimal financial system. Both bank- and market-based systems have flaws; so do the hybrid systems entailing major roles for both banks and securities markets, which are in fact the kind of systems that we observe in advanced economies. Whatever the structure of the financial system, the crisis problem will still be with us.

Second, the need now is not for more or less regulation, but for smarter regulation. Smarter regulation, in this instance, may mean going back to basics. It means cracking down on regulatory arbitrage, forcing banks to hold capital against the assets of their SIVs and conduits. In re-jiggering the Basel Accord, regulators have placed considerable weight on sophisticated constructs banks’ own internal models of value at risk. The crisis suggests that these are of dubious utility. Supplementing them with a simple minimum-capital/asset ratio, which banks would have to meet in addition to the ratio spit out by their VAR analysis, would be a prudent step back to basics. Keying that ratio to the rate of growth of the balance sheet, so that more capital had to be held during booms, would usefully offset the procyclical bias imparted by use of the banks’ internal models.

Third, securitization has risks as well as rewards. Issuing CDOs squared, whose performance characteristics not even most sophisticated investors can understand, enhances the welfare of no one but the financial engineers paid to construct them. At some point, surely, the opacity of a still-more-complex security means that the costs of the additional market risk thereby created exceed any risk-sharing benefits. The subprime crisis provides investors with a painfully effective reminder of these facts: hence the widely commented upon move back in the direction of plain vanilla securities.

The question is whether we should expect this move to be permanent or whether a new generation of investors will come along and, not having experienced that pain first hand, again fall prey to the siren song of complex derivative instruments. The record of crises past suggests that investors don’t always learn the lessons of history, or at least that they don’t learn them permanently. It would be unrealistic to assume that the current preference for plain-vanilla securities is permanent and that we will not eventually see a subprime-like mania in some other segment of financial markets. This means raising the stake of originators in the quality of the securities they issue, for example by requiring banks to retain



the equity or first-loss tranche of any security they issue. It means providing preferential access to the discount market for borrowers who offer relatively simple, transparent securities as collateral. It means encouraging the development of exchange-based as opposed to over-the-counter trading, since this is conducive to instrument standardization, more liquidity, and greater ease of pricing. More generally it means that bank regulators and market supervisors need to do more to anticipate these problems during boom times. They need to act like Ned Gramlich, not Alan Greenspan.

## ***Tackling Systemic Financial Risk***

Joachim Faber

*CEO, Allianz Global Investors AG, Board Member of Allianz AG*

### ***1. Transparency and Accountability***

#### *Observation*

Financial Reporting to shareholders and risk reporting to regulators and senior management has failed. All efforts through IFRS, US GAAP and Basle II have not prevented failures in risk evaluation by banks and regulators in the 3rd quarter 2007 nor have they been able to create transparency about the remaining risk position from the sub prime crisis with shareholders and clients. Hedge funds and private equity companies have developed a parallel banking segment which still has no transparency at all.

#### *Issues to Tackle*

- Greater transparency in external reporting on securities and derivative positions consolidated and unconsolidated.
- Improvement of internal risk management systems to give consistent, daily information on risk position to management; valuation of structured positions need to be improved.
- Hedge funds so far are completely excluded from any external reporting due to the fear of competition. At least the regulator has to have full transparency.
- Fair value accounting has proven not to be the solution. Accounting standards need to be rethought to avoid short-terms in balance sheets of the financial services industry. Our world will be unavoidably become more and more volatile because ever more participants with ever greater volumes are acting in the Global capital market increasingly in concert due to the ever increasing convergence at the second of relevant financial information. This volatility leads at times to fair values, judged by market rates, which are not fair anymore.

For financial institutions, particularly pension funds and insurance companies which are holding assets to cover liabilities with a duration of 10 years plus this leads to unacceptable consequences. Even for bank- and investment bank balance sheets a greater usage of the formation of an accounting unit for assets with a matching liability needs to be evaluated.

### ***2. Conflicts of Interest, Risk Illusion and Pro-Cyclicality (Rating Agencies)***

#### *Observation*

I agree that fundamental changes in the application of credit ratings in the capital markets should be addressed during normal times. However, I believe they need to be addressed.



The reliance on credit ratings of the major rating agencies has led, particularly with highly structured paper, to negligence and failure of due diligence with professional market participants such as traders, asset managers, loan officers, pension managers and monoline insurers.

What might be justified with a straight corporate bond or a government bond cannot be applied to highly structured bonds. The professional players in the financial industry cannot rely on a simple rating for far reaching decisions for their portfolio or their balance sheets. This has led to the completely unacceptable situation that some banks do not even have the brainpower anymore in house to properly evaluate some of the highly structured bond/loans. Any investor or banker has to make its own evolution of underlying credits and cash flows when taking such a risk on its balance sheet or into its fiduciary portfolio.

#### *Issues to Tackle*

- Regulators shall not refer in their rules to credit ratings.
- Any opportunity shall be found to create more competition between the rating companies (i.e., creation of a European and an Asian owned rating agency.)
- No rating agency shall participate as a structuring consultant and a rater in the same transaction.

### **3. Oversight and Regulation**

#### *Observation*

I agree that regulatory overkill must be avoided, however some of the highly dangerous developments of the recent months have to be mitigated in the future. I doubt whether regulators will ever catch up with the speed of innovation of the most highly skilled (and probably also most highly paid) brains of a given generation working as financial engineers in the financial industry. That's why it seems to be unavoidable to change some of the fundamental parameters and incentive structures.

#### *Issues to Tackle*

- Capital requirements for proprietary, non-client business related trading positions should be increased. I appreciate the difficulty of an exact definition, however, if regulators are not increasing the price tag on proprietary trading, we will see investment banking drifting away to hedge fund land with some small client applications. The permanent opening of the Fed's discount window to Wall Street needs to be followed by a tightening of regulations anyhow.
- Consolidation rules for off balance sheet vehicles need to be tightened. It has become clear that the criteria of legal or commercial ownership of the assets by a sponsor of a SPV for consolidation is not sufficient. What finally matters is the reputational responsibility deriving from the sponsorship of a SPV. This has become evident with regard to Special Investment Vehicles (SIV), but it has also become clear even with Money Market Funds which needed sponsor support in order not to endanger the NAV. Again, drawing the correct line in the sand might be difficult, but unavoidable.
- This discussion around a new set of banking rules will demonstrate that the global financial market needs a more homogeneous supervisory and regulatory frame work, otherwise the globalising capital markets will not be protected from another sub prime debacle.



#### **4. Moral Hazard and Systemic Risk**

##### *Observation*

The level of bail-out efforts of governments for the sub-prime damaged financial industry is significant and probably unprecedented. It is hard to imagine that a Bears Stearns bail out in the US or a SachsenLB or IKB rescue in Germany could have happened in other industries.

If the argument is right, that the systemic risk in the financial market is so large, that governments cannot afford to let a financial institution become insolvent (to complex to fail), than politicians and regulators need to look for different policy tools to avoid this situation in every cycle. As far as the US is concerned, one can argue that the root cause for the entire bubble was the accommodating central bank policy, thus policy makers should assume a certain responsibility for the crisis.

However it is hard to believe that a rescue effort of this dimension will not have a substantial tightening impact on regulations. Compared with the long lasting efforts to introduce Basel II, this might be a little easier, as much of the cause lies in the United States under the Fed and SEC supervision.

##### *Issues to Tackle*

- Central bank policy should be more responsible as far as monetary and financial stability is concerned.
- Resolution vehicles such as bridge companies concept should be established to provide for an orderly wind down of a failed investment bank or hedge fund. Bear Stearns and LTCM at immediate bankruptcy would have caused chain reaction in case of immediate bankruptcy which would have gone out of control. A rescue like Bear Stearns with major public budget is unsustainable.

#### **Tackling Systemic Financial Risk**

Pablo E. Guidotti

*Dean of the School of Government and Professor of Economics, Universidad Torcuato di Tella, Republic of Argentina*

The current ongoing financial crisis originates from a combination of factors. Two of them are particularly important: 1) a prolonged period of low world interest rates, and 2) financial innovation mostly associated with the US sub-prime mortgage market (e.g., CDOs, CLOs, securitization and tranching, SIVs). Regulatory arbitrage appears to have been a main motivation behind financial innovation: by allowing financial institutions to move assets out of their balance sheets, it reduced the required capital.

However, a first problem is that risk exposure was not eliminated, as financial institutions remained implicitly committed to providing liquidity assistance to maturity-mismatched SIVs, which funded themselves with commercial paper.

A second set of problems is that financial innovation weakened the incentives to correctly evaluate risk at origination, it generated highly complex instruments to value, and induced the shifting and elusion of basic responsibilities both by banks and regulators (e.g., the increased role given to credit rating agencies (CRAs) and insurers).

In my view, two conceptual issues lie at the basis of the above-mentioned problems. Firstly, financial innovation and higher diversification opportunities reduce the incentive to engage in the collection of information on specific assets, which is a costly activity (see Calvo G.,



"Varieties of Capital Market Crises" paper). Hence, it may not be surprising that financial innovation has weakened the traditional role of credit risk evaluation at banking institutions.

Secondly, regulation has evolved around the principle that the supervisor's main role is to monitor banks' own decisions (risk management), thus moving away from ad-hoc regulatory requirements. This begs the question of whether it is realistic to think that supervisors and regulators are able to keep the same pace of progress in understanding the risks associated with new and complex financial products in highly integrated markets, or whether they will always lag behind the private sector.

One final thought on the role of low interest rates (and monetary policy in the US). From the above discussion I would conclude that, although it cannot be denied that sustained periods of low interest rates facilitate financial innovation and (excessive) risk taking, the main responsibility behind the current turmoil lies with regulators and supervisors rather than with the conduct of monetary policy.

In thinking about proposed solutions, I would like to focus on three main areas: 1) regulation; 2) central bank operations; and 3) implications for emerging market economies.

### **Regulation**

1. It is important to go back and focus on simpler ways to ensure that capital is adequate to risk. The current way in which the regulatory and supervisory work is developed puts the supervisor at a disadvantage in terms of its effective capacity to identify and prevent regulatory arbitrage. Possibly, regulation should rely less on internal models, and focus more on how to decompose complex instruments into simpler components for which the capital charge assessment is clearer.
2. Attention should be given to the possibility of introducing counter-cyclical elements in prudential standards (for instance, higher loan-loss provisions in good times).
3. Regulation should rely much less on CRAs. The greater role assigned to CRAs has simply reduced banks' traditional investment in credit assessment. However, CRAs do not appear to have neither the capability nor the incentive to substitute banks' central role in credit evaluation. Compared to supervisors, CRAs do not possess enough powers to obtain all the necessary and timely information, and there are serious questions about how ratings change (or should change) in the midst of a crisis.
4. An increased focus on liquidity risk assessment and management is essential. In this respect, the work being done by the Basel Committee is important. I would consider seriously the potential benefits of imposing a quantitative requirement to hold a certain amount of unencumbered, high quality liquid assets as a proportion of short-term liabilities.
5. Increased attention should be devoted to the assessment of counterparty risk associated with new complex financial products and their markets.

### **Central Bank Operations**

1. The response of major central banks has showed that liquidity provision needs to be more flexible in terms of instruments, counterparties, and collateral requirement. In this context, it is desirable to develop guidelines as regards the international coordination of central bank liquidity assistance to institutions with cross-border activities.
2. Such international coordination should also be consistent with procedures and division of responsibilities vis-à-vis problem-bank resolutions.





## **Emerging Markets**

1. While direct contagion to emerging markets has been limited, in part because of stricter regulations regarding cross-border exposures, the policy response of major central banks raises the possibility of an indirect transmission channel. If the liquidity expansion by major central banks eventually leads to a generalized increase in inflation, then a reversal of the monetary policy stance in the future may bring back the potential for renewed episodes of sudden stops in capital flows. In this context, it is desirable that the international official community works towards the creation of a new rapid-access liquidity line at the IMF that resolves the problems of the extinct CCL.

2. The policy response to systemic financial risk in advanced economies is anchored on the public sector's fiscal capacity and creditworthiness. In emerging markets, however, the public sector's response capacity in similar circumstances is much more limited by incomplete credibility. It is important that the enhancements on institutions and regulations that emerge from the current crisis in advanced economies is also adapted to the characteristics of emerging market economies in order to improve their strategies for crisis prevention and resolution.

## **A Few Topics for Ageing Discussion**

John J. Haley

*President, CEO and Chairman of the Board, Watson Wyatt Worldwide*

### **Increasing Labor Supply in the Developed Economies**

- Nearly all advanced economies face shrinking labor forces in the coming decades.
- Attracting more women:
  - Women entering the workforce was a major source of new talent that fueled labor force growth in the U.S. over the last half of the 20th Century. That trend is nearly over.
- Attracting more older workers:
  - Restructuring retirement incentives in our pensions.
  - Working around the productivity puzzle created by seniority systems.
  - Flexibility in the structuring of jobs and utilization of the older people who fill them.
  - Men throughout the advanced economies are working longer.
- Attracting more immigrants and more productive immigrants:
  - Net migration rates have tripled during the last 50 years.
  - Socioeconomic factors.
  - Demographic imbalances between developed and developing countries.
  - Recent migration policies are biased toward the highly skilled:
    - 1990 US Immigration Act.
    - United Kingdom Highly Skilled Migrant Programme.
    - Scientist or specialists' visas in Germany and France.
  - APAC: Main providers of highly skilled immigrants, in particular: China and India.
  - 70% of Mexico's migrants did not complete secondary studies.
  - Eastern Europe countries show great variance:
    - 50% of Russian emigrates have received tertiary education.



- 40% of emigrants of other Eastern European countries are clustered in the middle category.
- India and China are losing less than 4% of their generated talent.
- HK is losing 25% of its talent to developed countries.
- Labor capacity lost to emigration is important in the context of who pays for that education and who reaps the reward.
- Immigrants needed to offset low fertility rates in various countries.

#### Enhancing Worker Productivity

- Have we entered a new era of productivity growth?
- Moving production offshore

#### Pension Reform: Managing Increased National Savings

- State pension sponsors should consider world market place to invest.
- Eliminate inherent or specific legislative biases against cross - national investment of pension assets.

#### Health Care Reform

### **What Does “Systemic” Financial Regulation Mean?**

Avinash Persaud (John Eatwell)

*Chairman, Intelligence Capital Limited*

A peculiar characteristic of financial regulation today and one of the causes of its failure has been the divergence of economic theory and practice. Recent proposals by regulatory and banking lobbies appear to be continuing this divergence. In theory it is generally accepted that the core purpose of financial regulation is to mitigate systemic risks, like a global credit crunch. Such risks are externalities. Their cost to the economy as a whole is greater than the cost to firm whose actions are creating the risk. However, in practice, the regulatory principles of the New Basel Consensus, propounded by bankers and regulators alike, are focused entirely on risk-taking by individual firms.

It is a failure of composition to think that by encouraging good behaviour at the firm level, the system will inevitably look after itself. One of the striking things about the report requested by the Swiss supervisory authorities into the troubles at UBS is that much of what they did was considered best practice. But, as economic theory also points out, if everyone is efficiently applying the same information to the same tastes, the system will collapse. Of course, as environmental regulators have found formulating practical “systemic” policies is far from easy. Measurement of externalities is inevitably imprecise. But in the light of the substantial adverse economic and human effects, giving up is not an option. Regulators have asked us, “but what would systemic regulation look like”? The following three new proposals provide a flavour.

*First*, whilst financial institutions are encouraged by supervisors to conduct thousands of stress tests, few are conducted by the regulator on a system wide scale. If it possible to have system-wide stress tests on the impact of Y2K, or of avian 'flu, why not on liquidity? The regulator should conduct system wide stress tests of those scenarios most likely to produce systemic stress – such as a 40% drop in house prices. Fears of a meltdown in global house prices were not rare before the crisis. The information gleaned in this exercise should feed into regulatory measures that might be quite different from those suggested by the risk management of an individual firm. After all, banks end up putting their resources in places



where their individual risk management systems tell them has been safe in the recent past, generating systemic concentrations.

*Second*, Willem Buiter's proposal that regulation be targeted on highly leveraged institutions, whatever their formal legal status, is an important step toward a comprehensive regulatory framework. We would add a distinction of leverage with short-term funding. Many years ago the only significant highly leveraged institutions were commercial banks. Today, leverage is a characteristic of firms throughout the financial system, whether they are deposit taking banks, investment banks, hedge funds, mutual funds, private equity firms or insurance companies. And it is this leverage when coupled with short-term funding liquidity, that threatens market gridlock in a disintermediated financial system. We need to switch the attention of the central bank and the regulators from an institutionally-defined approach to a functionally-defined approach. Institutions are not born with original sin, or original virtue, it is their behaviour that can have potentially damaging systemic implications. It's the spread of pollution that matters, not the legal entity of the polluter.

*Third*, a clear distinction must be made between a capital charge à la Basel, and provisioning that is available to cover losses in a downturn. One of the main problems is that a minimum capital requirement is a charge, not a buffer. If resources are to be available in the downturn then, if they have been compulsorily accumulated, they must be freely released. Goodhart and Persaud (FT June 4) and others have suggested that capital charges should be raised in a boom and relaxed in a slump. There are complicating issues (see also Stephany Griffith-Jones, FT Letters, June 13): How to deal with the case of banks operating across a number of different markets? The result can only be approximate, but it would still be far better than the pro-cyclical approach we are stuck with now. The point is contra-cyclical provisioning should be based as much as possible on systemic phenomena and less on the characteristics of the individual firm.

These three measures are practical steps toward the regulation of systemic risk. There remains the cross-border problem. Many sensible proposals are wrecked on that particular rock. But if widespread improvement is to be achieved then the Basel Committees and the Financial Stability Forum must shift away from reliance on the usual suspects of greater transparency, more disclosure and firm-based risk management, and develop practical systemic proposals.

### ***A Party Pooper's Guide to Financial Stability***

Avinash Persaud

*Chairman, Intelligence Capital Limited*

Few will envy Lord Turner's new position as chairman of the UK's Financial Services Authority. Almost 12 months on from the start of the credit crunch and eight months since the run on the Northern Rock bank, there is a developing consensus on what is to be done to make the financial system less vulnerable to crisis.

The bad news is that it is largely the same consensus we reach after every crisis, ultimately to little effect: more disclosure, more regulation and reform of bankers' compensation.

These are generally desirable, and where there is a will there is a way. There lies the problem. Financial supervisors had the wherewithal to do something about the party in the financial sector that was played out in full view of everyone between 2003 and 2006 but they did not have the will to do it.

It was William McChesney Martin, former US Federal Reserve chairman, who argued the authorities should "re-move the punch bowl before the party gets going". But parties are fun.



Underpaid supervisors cannot easily squeeze past powerful and rich lenders, borrowers with seemingly worthy projects and politicians taking credit for the good times, to take away the bowl of punch.

But it must be done. We propose two devices to strengthen the backbones of regulators and supervisors.

Some argue it is not regulators and supervisors but monetary policy committees that should perform the role of official party pooper. Yet interest rates changes alone cannot deliver both price and financial stability. Asset bubbles often follow periods of price stability (US 1929; Japan 1990s; Asia 1997-98; subprime mortgages 2007-08). Moreover, the level of interest rates required to prick a bubble might eviscerate the rest of the economy.

Much attention has been paid to the fraught task of aligning bankers' bonuses to longer-term outcomes. But it will be easier to amend supervisors pay, to similar macro prudential effect. If supervisors received large annual bonuses that were withheld for five years and paid conditionally on successful supervision during this period, they might be more willing to remove the punch in time – thereby limiting bankers' bonuses in the first place. To avoid excessive regulatory zeal we would need independent assessment of supervisory success, with some input from the industry.

It would need to consider such issues as widening access to finance as well as minimum cost to the taxpayer.

To help supervisors act as a countervailing force to powerful procyclical forces, we propose a simple framework that raises Basel II capital adequacy requirements by a ratio linked to the growth of the value of bank assets, bank by bank. Focusing on value will help lessen the procyclicality of fair value, mark-to-market accounting and value-at-risk models.

Sceptics say the devil is in the detail or that the growth of banks' balance sheets is not a good measure of their riskiness, even though most systemic bank failures have been preceded by excessive growth of bank asset values. We do not disagree, which is why we are piggy-backing on the existing Basel II scheme, which attempts to weight relative riskiness of assets (and addresses off-balance-sheet liabilities). Our purpose is to moderate excessive lending and build up reserves during booms.

Here is how it could work in practice. Rather like income tax, each bank would have a basic allowance of asset growth, which would be linked to the inflation target, the long-run economic growth rate and some margin for structural changes in the bank lending/gross domestic product ratio. This formulation enables regulators' financial stability committees better to link micro to macro stability. Allowances would be different for small operations.

Growth in the value of bank assets would be measured as a weighted average of annual growth. To emphasise more recent activity, exponential weights can be used. Growth above the basic allowance over the past 12 months would have a 50 per cent weight, growth over the preceding year would have a 25 per cent weight and so forth until 100 per cent is approximated. Regulatory capital adequacy requirements would be raised by 0.33 per cent for each 1 per cent excess growth in bank asset values. If a bank grew its assets at a rate of 21 per cent above its allowance, its minimum capital requirement would rise from, say, 8 per cent to 15 per cent.

Bankers will howl as loudly as those currently defaulting on their homes. But this proposal is evolutionary, since it builds on Basel II; and it provides a simple, transparent rule for supervisors to play a useful counter-cyclical role. But they must be given better incentives to do so. We have seen the deleterious but powerful effects of banking bonuses. Why not use financial incentives for more socially useful behaviour?



## **Tackling Systemic Financial Risk**

Yutaka Yamaguchi

*Former Deputy Governor, Bank of Japan*

1. Financial crisis will not go away. Our capitalist market system is bound to produce occasional excesses. If anything, liberalized and globalized financial markets tend to amplify such swings. Indeed the frequency of financial crisis in the last few decades testifies to such observation.

2. It is important to recognize that a system-wide financial distress, involving a large number of undercapitalized and insolvent firms, is usually the consequence of credit boom gone sour. The role of credit is critical both as the “financial accelerator” and as the source of systemic crisis. If credit expansion is somehow kept moderate during the economic upswing, then the non-performing assets left behind will be smaller and insolvent institutions less than when the credit growth was left unchecked. To help moderate procyclicality, dynamics between economic and credit cycles, appears to be the core challenge we have to face.

3. In my view, both prudential and monetary policy has a role to play. As regards the former, the greater risk sensitivity in Basel 2 and the role of fair value accounting are obvious candidates for scrutiny. Such review is under way at the Financial Stability Forum; it also involves detailed analysis of “nuts and bolts” in financial practice and regulations. We might as well express our deep concern and interest on the subjects, and wait for the FSF (and possibly other) works to be completed.

4. I would briefly discuss possible roles of monetary policy. The conventional wisdom in the past decade or so has been that monetary policy should not try to “prick bubbles”. It should instead address forcefully the negative fallouts when the bubble collapsed. The Fed easing in the post tech-bubble years (2001-2003) has been referred to as the model policy response. What is not clearly said about that episode is that the tech-bubble was not accompanied by massive inflow of credit, a major reason why the financial system emerged relatively unscathed from the aftermath. One should be careful in generalizing that particular experience. Facing a typical credit cycle, with asset market fueled by rapid credit growth, the central bank should be more vigilant even when inflation outlook is benign. A monetary tightening should not be ruled out to restrain credit acceleration, not targeting on asset price per se. (This last point with emphasis.) Admittedly the effects of such policy would be uncertain. My own experience in the past suggest that monetary and prudential policies should work together to produce better results. A formidable challenge.