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A New Financial Architecture

The Issing Committee corralled some of the best minds in banking and financial supervision. Here's what they concluded.

In an environment of inadequate regulation and gaps in supervisory oversight, inappropriate incentive structures have encouraged the production of complex financial instruments supported by high degrees of leverage. The situation in booming financial markets became more and more unsustainable, needing only a trigger to collapse. This trigger was delivered when house prices in the United States started to fall with the expectation that this would continue for an extended period of time.

INTELLIGENT TRANSPARENCY: THE RISK MAP

In the current crisis, central banks, supervisors, and deposit insurers were not fully aware of the extent, the interconnectedness, and the systemic risks emanating from the shadow banking system that had evolved over the past several years, comprising off-balance sheet entities as well as risk transfer instruments like collateralized debt obligations and credit default swaps. A coordinated effort to set up a suitable database of the global financial interconnectedness and its major risk factors is needed. We call this "intelligent transparency," and propose creation of a Risk Map.

Participating agencies with regional expertise, chaired by the International Monetary Fund, should develop a proposal defining the conceptual back-bone of the Risk Map project. Since data analysis alone does not suffice to spur appropriate market discipline and trigger interventions by regulators, a pre-arranged link is needed between the results of the data analysis and a set of policy actions.

Investors need enough information to be able to assess the risks of financial instruments correctly. In securitization transactions, the economic first loss position must be described and its allocation in the market treated as a bond covenant, disclosed to the market, thereby avoiding opaqueness of bank portfolio risk.

CREDIT REGISTRY

Given the current high level of international lending and exposures, a global credit register would greatly enhance risk management, both at the firm level and at the systemic level. Similarly, a unified approach to exposures in areas such as bonds and stocks would add the international capital market dimension to the picture of corporate and bank risk exposures. Credit register information extends the information aggregated under the Risk Map project in the direction of major bank borrowers.

We propose a centralized approach to setting up a standardized credit register that is capable of mapping domestic and cross-border exposures simultaneously. Likewise, the advancement of a global securities register should be continued in parallel, exploiting possible synergies. However, even the best register will not be able to provide an account of total bank exposures in real time.

REGULATION AND SUPERVISION

The existing regulatory and supervisory system has important weaknesses and gaps.

- Financial institutions should be supervised on a fully consolidated basis to inhibit the scope for regulatory arbitrage. Investment funds operating inside banks, insurance companies, or non-financial corporates should be supervised comprehensively. All systemically important financial institutions should be subjected to appropriate supervision and regulation.
- Market participants should urgently implement central counterparty clearing for over-the-counter credit derivatives.
- Compliance of offshore centers with relevant regulations could be improved through an "indirect" approach if all major financial centers cooperate.
- Capital requirements should be tightened after the current crisis has passed. Introduce an additional overall leverage ratio in addition to the risk-weighted Basel ratio. Require additional capital for SIVs, conduits, and off-balance-sheet activities unless they are fully consolidated. Also, require additional capital for lending to hedge funds and non-cooperative offshore centers. Allow for liquidity risks.
- Improve information flow between national supervisors to obtain a complete picture of the situation of cross-border

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Summarized from "New Financial Order: Recommendations by the Issing Committee" (November 15, 2008, and February 2, 2009).

banks, bank holding companies, hedge funds, and other investment funds. Create "global colleges of supervisors" for cross-border banks.

- Improve consistency in the regulation of different financial entities such as banking, insurance, and securities.
- Enhance interaction between institutions with experience in assessing macro-prudential risks and those in charge of assessing micro-prudential risks.

INTERNATIONAL INSTITUTIONS

To strengthen the role and effectiveness of the IMF, the Bank for International Settlements, and the Financial Stability Forum, two broad issues need to be addressed: legitimacy and focus.

The IMF should continue quota adjustments in favor of the emerging market economies. More of the Fund's executive directors should come from developing countries, and European representation should be reconsidered. The IMF should intensify its work on financial market issues, in particular on the spillovers between financial markets and the real economy, the assessment of macro-prudential risks, the collection of financial market data, and the monitoring of the implementation of agreed standards and codes.

Note the limits of what can be reasonably expected from the IMF. There is an unavoidable trade-off between the neutrality of the work of the IMF staff and the political interests of its shareholders. The IMF does not have the expertise to act as standard setter for financial markets, and does not appear to be suitable to become a global supervisor for the largest international financial institutions.

The BIS suffers from a lack of legitimacy and should broaden its membership. Key committees of the BIS should be expanded beyond G10 countries to include the largest emerging market economies as full members. The BIS is the standard setter in financial markets. It will be the key body to adopt most of the measures proposed. The BIS should close gaps in the regulatory and supervisory system, tighten capital requirements, and review the procyclicality of the system.

The Financial Stability Forum is the key forum to coordinate and advocate regulatory and supervisory reforms. But it also suffers from a lack of legitimacy as it is G7-dominated. FSF membership should be expanded. The FSF should identify gaps in the regulatory and supervisory system and guide the implementation of reforms carried out by its members.

The FSF should continue to be anchored at the BIS but the links between the FSF and the IMF should be strengthened. A merger of the FSF with the IMF appears neither feasible nor efficient.

RATING AGENCIES

By carrying over a well-established methodology from bond markets to more complex, structured finance products, the rating firms acted thoughtlessly, and indeed irresponsibly, eventually wreaking havoc to the agencies' credibility.

Internationally active rating agencies should be registered with an institution entrusted with capital markets oversight, such as the IMF or the BIS. This institution will analyze and publish data on rating agency performance. Rating fees may be linked to rating performance. To minimize rating shopping, unsolicited ratings are encouraged. Authorities should continue to review their use of structured finance ratings in the regulatory and supervisory framework and reduce the use to the extent possible in order to limit the pressure on agencies.

MANAGEMENT COMPENSATION

Management incentives have increasingly focused on short-term performance, disregarding longer-term risks. Since the compensation system influences management behavior, a stronger reliance on long-term performance of investment strategies is required. Such schemes could resemble pension annuities rather than all-cash-out payments, and involve both bonus and malus components.

Incentives in management compensation schemes should be disclosed. Rating agencies and other information providers such as auditors should be encouraged to report a firm-level metric that captures incentive alignment. Mandatory rules on management compensation, such as salary caps or bonus limits, are not advocated, as they are expected to backfire.

HEDGE FUNDS

Hedge funds tend to take large risks, often accompanied by high leverage. There is no indication yet of a prominent role of hedge funds in the genesis of the crisis. However, hedge funds played a role in crisis transmission, due to their strong reliance on bank financing and maturity mismatch. In the crisis, these characteristics contributed to procyclical behavior, in particular to deleveraging and asset sales, which both had a negative impact on market liquidity.

A mixture of direct and indirect hedge fund regulation is proposed. Hedge funds should register, providing a unique identifier, domicile, ownership structure, management advisor, and investment objectives. The hedge fund data base will be stored in a publicly accessible register, possibly as a part of the Risk Map project. The structural information can (and should) be complemented by balance sheet information.

Actual systemic risk oversight should be directed primarily at the major banks providing funding, counterparty positions, and transaction services to single hedge funds. Registration provides the necessary information to link any registered hedge fund with all of its brokers, thereby showing the consolidated exposure of the financial system with regard to hedge funds.

THE EUROPEAN DIMENSION

The current financial crisis has also highlighted the weaknesses in the European Union's supervisory framework, which remains fragmented along national lines. Reform of the European supervisory framework is essential to protect the Single Market and the euro and needs to go beyond what is feasible globally. ◆