



MANAGERKREIS DER FRIEDRICH-EBERT-STIFTUNG

Lessons from the Financial Crisis

**Discussion paper by the Permanent Working Group on Financial Policy, Taxes, Budget
and Financial Markets of Managers in the Friedrich Ebert Stiftung**

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Introduction: Aspects of the Financial Crisis

When the current financial and economic crisis began in mid-2007 – back then we were just talking about a “subprime crisis” – it was assumed that this was a problem with worthless U.S. mortgages that would remain restricted largely to the American market and in particular to this specific asset class. That was not the case. By autumn 2008 there was a real danger of the entire global financial system falling apart. What followed was a deep and above all synchronous collapse in global demand and production.

Measures must be introduced to reduce the likelihood of similar crises recurring, and above all to do everything possible to exclude a systemic banking crisis. Action is needed on supervision and regulation.

If systemic banking crises are to be contained, structural and regulatory consequences need to be drawn. Until now accepted wisdom has defined efficiency in the banking market as a situation where the few players left are as large as possible and reap the maximum possible return on equity. It is time to set that whole approach aside, for it has turned out to be anything but expedient for a healthy supply of business credit, nor has it produced results in terms of financial market stability.

Fundamental observations

1. It was a mistake to assume that the financial markets are capable of even partial self-regulation. The process of widespread deregulation was in fact one of the underlying causes of the financial crisis.
2. It has become clear that a return on equity exceeding 20 percent cannot be maintained over time. Even in the short term such returns can be achieved only at the price of entering into great risks.
3. The process of strong disintermediation that took place in the traditional deposit-based banking sector in advance of the crisis turned out not to be viable. Rather than squeezing out financial intermediaries in favour of loan securitisation, what is needed is for the banks to return to their classical transformation functions. The banking sector must focus more strongly on the real economy, especially expanding the “principal bank” function and direct customer relationships.

1. The German Banking Market: Structural Policy Guidelines

1.1 The necessity of state intervention in the banking market

The banking sector needs a different regulatory framework from other sectors of the economy, because the possibility for actors to be “punished” by exclusion from the market is very limited or non-existent.

Adequate transparency and state supervision of risk are therefore essential:

- Risks must be recognisably accounted and not be removed from bank balance sheets.
- The regulatory framework must set proper incentives for sensible and productive behaviour in the markets.

Sweeping deregulation of the financial markets turned out to be a boomerang. So deliberately creating international financial conglomerates and breaking open traditional banking structures cannot be the way forward for structural policy.

1.2 Preserve pluralist structures in the banking sector

The German three-tier banking system (state-run, private and co-operative banks) has demonstrated its resilience and represents a significant competitive advantage for Germany. It prevents herd behaviour in the markets and strengthens competition.

The crisis-resistance of the German savings banks shows that it remains imperative to have a public-sector banking system in local authority ownership.

But within the public-sector banking system the business orientation of the state banks (“Landesbanken”) needs to be reconsidered. Capital market speculation on their own account cannot be their primary business strategy. The *raison d’être* of state banks is to supply credit to regional SMEs together with the savings banks.

1.3 Tackle the risks of system-relevant banks

Banks that are “too big to fail” expose the state to blackmail and distort the economy as a whole. In a crisis there is *de facto* no alternative to intervention and support; this restricts the state’s fiscal options and especially leads to neglect of state investment needed in the wider economy.

Both at the fiscal level and the market level “too big to fail” produces system-destabilising risks:

- Excessive risk-taking: The expectation that a large credit institute will receive state support if things go wrong can lead to excessive risk-taking. This implicit state guarantee tempts management to enter into greater risks than if the bank were expecting to bear all risks and losses itself (moral hazard).
- Distortion of refinancing costs: Because of the implicit state guarantee for big banks the effective return – that should be tied to the risk class of the investments – becomes almost independent of the actual risk associated with the financial business conducted by the bank. As a consequence, big banks have lower refinancing costs than smaller institutions in any given risk class.

- Trend to size regardless of achievable synergy effects: The refinancing advantage created simply by size (and the resulting implicit state guarantee) leads banks to expand and merge beyond their ideal economic size. The consequence is an oligopolisation of the market with negative welfare effects.
- Financial blackmail of the state and restrictions on state alternatives: Citing their vital role for the stability of the system, big banks can basically force the state to provide financial support if and when they need it.

This situation where big banks profit individually from their pure size while potentially burdening society with enormous costs urgently needs remedying. At the same time, there is a certain tension here with the desirable objective of consolidating and deepening the European internal market in financial services, which inevitably means banks operating internationally. It would not be desirable to split up financial institutions ex ante because this would have the effect of renationalising the internal market.

Instead it would make sense (1) to avoid misincentives by establishing regulatory measures to more adequately price in the risks of bank business and (2) to create instruments designed to ensure that large active banks no longer present a risk of financial blackmail. Various approaches are conceivable here:

(1) Stronger prevention of especially risky bank activities

Dealing with risk is central to the banking business. But the return must match the risk; in other words, risks must not be externalised. In a switch from current practice, high risks must be coupled with high costs as well as high potential returns. The greater risks involved in particular transactions must be reflected in higher risk costs in the form of capital adequacy requirements, liquidity cushions and risk management provisions. This is imperative if we are to prevent “casino” banking activities from endangering economically important banking functions (“utility” banking). The inherent control and incentive effect of higher risk costs reduces the taking of excessive risks.

(2) Manage the complexity of big banks

(A) Large, internationally active credit institutes must draw up resolution plans that allow the economically relevant banking functions to be separated out quickly and easily if need be. Supervisory authorities, politicians and central banks must make it clear that functions that are not absolutely necessary for the economy (“casino” banking) will be wound down in a controlled fashion rather than rescued, for example via special purpose entities. An orderly winding down procedure is essential in order to avoid dislocation in market pricing and counterparty positions.

(B) Resolution (or wind-down) plans can be backed up by establishing a Chinese wall within large, internationally active banks. Binding equity capital allocations between “utility” banking and “casino” banking (that may be altered occasionally but on no account in a crisis) would prevent “utility” banking equity being used to make up losses from the “casino”.

(C) The idea of subjecting banks that are important at the European level to a levy staggered by size needs to be considered. A levy that increases with the size of bank would internalise the market-distorting advantages that large banks enjoy on the grounds of their implicit state guarantees. This can be combined with a crisis intervention fund for large, internationally active banks (early intervention system). Such a levy would in the first place be a Pigovian management measure.¹ As its function is oriented towards systemic risk, the European Systemic Risk Board is the obvious entity to deal with such a proposal.

2. Europeanisation of Supervision and Deposit Insurance

2.1 New European supervision structures for the financial markets

The currently discussed new European supervisory system comprises two central components:

(A) The European Systemic Risk Board (ESRB), responsible for macro-prudential supervision.

(B) The European System of Financial Supervisors (ESFS), responsible for micro-prudential supervision (institute level).

The establishment of a European Systemic Risk Board is especially innovative, satisfying the need for a macro-prudential supervisory component (i.e. taking into account explicit macroeconomic developments and intersectoral effects of institute-specific supervisory decisions).

It is necessary, and in the interest of a stable integration process, for the newly created European supervisory regime to take adequate account of national and regional differences in banking markets. It would therefore be of concern if the European authorities were to acquire direct powers of intervention in the banks in question, above and beyond their power to set uniform standards of supervision. The right of the European Parliament to be involved in the development of supervisory standards must also be assured.

The question of an emergency plan for coordinated intervention in the event of serious liquidity or solvency problems at internationally active banks has yet to be satisfactorily resolved.

2.2 The European Commission's proposals for harmonising deposit guarantees

A certain minimum degree of harmonisation is required for the functioning of an internal market in banking services. It makes sense to harmonise the definition of who is protected, the range of protected products and the compensation payout periods. But neither a pan-European safety net nor maximum limits are necessary for the functioning of an internal market.

The measures taken thus far at the European level are sensible. Raising the minimum protection from €20,000 to €50,000 (and later €100,000) helped to reassure depositors. However, the creation of a pan-European deposit guarantee scheme would be unnecessary and counterproductive. Yet another reform of the deposit guarantee directive within such a short space of time would provoke discussion about a suspected lack of viability of the existing systems and lead to a fundamental debate about the credibility of the new system. The German deposit guarantee arrangements especially have proven to be viable in systemic crises and enjoy great credibility among depositors. Above all, a pan-European deposit guarantee scheme lacks credibility because it cannot resolve the central question of burden sharing. A situation of widespread instability would potentially require a state guarantee for the deposit guarantee scheme. However, due to the fact that the European level does not possess any tax-raising powers such a guarantee can only be given by the nation-states. Furthermore, it is hard to imagine a national government giving a guarantee for a pan-European scheme. Therefore, this deposit guarantee scheme lacks fundamental credibility, ultimately rendering it useless.

Moreover, it has yet to be clarified whether a pan-European deposit guarantee scheme is covered by existing powers at the EU level, especially in terms of the implicit fiscal burdens that would be involved for the member states.

During the turbulence of autumn 2008 the German deposit guarantee arrangements were a decisive factor for maintaining confidence. Again demonstrating what this system is capable of in an exceptionally critical situation. Any measure should be strictly rejected which could endanger the existence of the German deposit guarantee arrangements, possibly weakens the depositors' confidence in the security and functioning of the existing systems or lowers the existing level of protection.

If at all, only banks that are actually internationally active should be included in the scope of any pan-European system. The contributions must be graded according to the risks on the balance sheet. Voluntary institute-specific systems offering a greater degree of protection must remain permissible.

2.3 Raise capital adequacy requirements, but in line with risk

A central point of criticism of the current capital adequacy requirements is that they act cyclically and thus have no stabilising effect on either the banking sector or business financing. The rules allow the institutes to reduce their capital backing or expand their business in good economic times but force them to increase their capital backing or contract their business when risks appear. Dynamic value adjustment to cushion expected losses – as already practised in Spain – or dynamic equity cushions to cover unexpected losses represent two possible ways forward. However, prior to their implementation it would be important to thoroughly investigate the quantitative effects of such cushions.

The current accounting rules have also contributed to the occurrence of equity shortages. Growth in market value can be entered in the books and paid out, leaving no cushion to cope with any subsequent fall in market value. In future it will be necessary to put clear limits on the risks posed by system-relevant banks. Larger equity reserves are certainly one element. Simply raising the capital adequacy requirements across the board would not be very helpful; it would restrict the banks' ability to lend without actually tackling the systemic risks. Instead, higher capital adequacy requirements should be applied especially for high-risk derivatives.

No additional stability is gained by redefining equity in Anglo-Saxon terms (i.e. only subscribed voting shares and open reserves). There are no objective grounds for placing such a restriction on the definition of core capital, because the capital instruments concerned share possible losses just like equity and therefore possess equity qualities. Efforts to artificially define core capital more narrowly (for example largely excluding capital contributions of dormant partners) therefore point in the wrong direction.

2.4 Set the right incentives in the banking sector

The first and central point is for minimum standards to be observed in lending. These include careful scrutiny of creditworthiness, solid loan-to-value ratios, emphasis on long-term financing and a requirement that the borrower contribute equity of his own.

Securitisation is a fundamentally useful financial instrument that allows banks to control their credit portfolio and gain leeway for more lending. But it is important to impose a greater degree of responsibility on the vendors of structured securities through compulsory self-retention. Also, the investor must be clearly informed of the ultimate purpose of the securitisation. Whether the proposed self-retention of 5 percent will suffice to bring about responsible use of securitisation remains to be seen. A higher self-retention rate would certainly have done more to stem the risks of lax lending under the originate-to-distribute model.

The way existing bonus structures largely reward short-term risk has contributed to destabilisation of the financial system. Remuneration structures should not offer incentives for

excessive short-term profit maximisation to the detriment of the long-term viability of the business. In this context tougher liability rules are also necessary to act as a deterrent to high-risk destabilising decisions. If variable payment systems are retained, multi-period bonus structures are needed.

2.5 Consumer protection: What is necessary and appropriate?

The German government has already extended the period of limitation for claims for negligent advice and from 1 January 2010 introduced a comprehensive obligation to record investment counselling and discussions concerning financial instruments as well as – under certain circumstances – a right of revocation following advice given by telephone.

It should not be forgotten, however, that tighter regulation does not automatically induce better investor protection. Indeed, too many regulations or hindrances can lead to a situation, where simply less advice is offered and investors are left to fend for themselves. In any case, regulations that ostensibly serve consumer protection but are not in fact welcomed by investors should be avoided, for example audio recording of meetings.

Instead, individual fields where further action would be useful should be identified, and existing loopholes in regulation and supervision need to be located and closed:

- To protect investors, fundamentally comparable and appropriate rules should apply to all market participants, in tandem with effective supervision. This applies in particular to the vendors of financial products. Improved qualification requirements should be set to ensure uniform standards and regular updating of knowledge. There are also considerable deficits in investor protection in the “grey market”, which needs to be placed under tighter regulation and supervision. Regulations that fail to serve their purpose should be withdrawn.
- Prudent investment advice means putting the customer’s economic circumstances, investment goals and risk preferences first. Any recommendation must correspond with the customer’s interests. Sales pressure or incentives to sell particular products must not be allowed to lead to short-term profit targets being given priority over the investor’s interests. Here there are already legal provisions in place, but their effectiveness needs to be reviewed.
- Even if the opportunities and risks of the investment are by nature borne by the investor, investment advisors must ensure that the investor is able to make a decision on a well-informed basis. Here there is room for improvement. Both the banks and their customers complain about the mountains of paper the banks have to issue; this is a consequence of the recently implemented reforms. Information for investors should focus on being brief, comprehensible and to the point rather than complete and comprehensive. Here it could be useful to create a European standard for summaries for particular product groups.
- Another task for politics and the banking sector is to improve citizens’ financial literacy.

3. Regulatory Markers for Stable Financial Market Structures

3.1 Dealing with the systemic importance of rating agencies

The rating agencies played a big role in fuelling the boom in subprime securities and thus ultimately also the U.S. housing bubble. Over many years they drastically underestimated the risks of securitised products. This was an outcome not only of inadequate valuation models, but also of distorted incentives: the agencies profited more from giving positive ratings than from negative ones.

It is also worrying that the oligopolistic market structure has led to a synchronisation of risk assessment by just a few firms. Here, in the absence of pluralism, there are dangers produced by herding, as well as a risk of market manipulation.

Due to the importance of the stability of the financial markets, rating agencies need to be subjected to effective supervision. The first step at the European level has been taken, with legislation for regulating the rating agencies passed in mid-2009 by the European Parliament and the EU Council. It remains to be seen whether the goals pursued by the decree will be achieved.

3.2 Accounting

It was already apparent at an early stage in the financial crisis that market value accounting considerably exacerbated the problems by forcing fire sales. Accounting on the basis of fair value leaves bank balance sheets extremely vulnerable to price fluctuations in the corresponding financial markets. When listed asset prices collapsed, the banks' balance sheets imploded immediately. The write-offs required by falling prices eroded the banks' equity and forced them into emergency sales – which further worsened the drop in the markets. In times of boom, conversely, market value accounting generates exaggerated profits when asset prices rise across the board, leading to an excessive expansion of dividend and bonus payments.

From a theoretical standpoint the existing rules can be criticised for focusing too strongly on the perspective of the individual economic actor and ignoring systemic implications. Another point is that the fair value principle implies that market value is always the same as true value. But such perfect information efficiency does not exist in reality. Instead price bubbles and market corrections flow directly into bank balance sheets. So accounting purely according to current market prices generates extreme fluctuations in recorded profits while failing to draw a realistic picture of the long-term prospects. This inherent pro-cyclical bias in fair value accounting thus amplifies the systemic risk in the banking sector not inconsiderably. What we need are accounting rules that are designed for a long-term perspective extending over the whole economic cycle.

The primary purpose of accounting is to draw the most reliable possible picture of financial status and profitability. Market value accounting has been found to be largely inadequate to that task. It is questionable whether the current “Expert Group on Accounting Rules” possesses sufficient democratic legitimisation; accounting arrangements are much more than a mere technicality. Thus the whole approach of market value accounting and the institutional methods by which rules are set must be fundamentally reconsidered.

3.3 Stock market and financial infrastructure

The crisis has shown that the financial markets also need robust structures for settling transactions. Widespread OTC trading in derivatives creates a situation devoid of transparency and lacking reliable hedging.

Establishing central counterparties for settling derivatives transactions is the way forward. Such clearing houses could be provided by existing operators of futures exchanges. Introducing such intermediaries would make derivatives trading less precarious (i.e. if one market actor fails, negative effects on other market participants and the whole market can still be avoided) as well as making the risks involved more transparent. Central settlement instances would also open up the possibility for supervisory authorities to gain a comprehensive insight into the market, which is not possible with bilateral trading.

In order to allow settlement via clearing houses, financial derivatives would have to be largely standardised. Furthermore, traders would have to supply the clearing house with adequate securities. Here it must be ensured that these new infrastructures are available not only to large market participants, but that efficient access is also guaranteed for smaller market participants.

3.4 Liquidity rules

Turbulence on the money and capital markets has underlined the significance of efficient liquidity risk management for the stability of individual banks and for the whole financial system.

At the moment at the international level there are no uniform standards of regulatory oversight of liquidity risk. The new rules – especially the proposals of the Basel Committee – represent the first step towards a regulatory standard for managing liquidity risk.

The rules provide above all for larger liquidity reserves at the banks to allow them to survive short-term stress periods without running into liquidity shortages. Banks would also have to test much more frequently the extent to which particular market dislocations would lead to refinancing problems.

4. Financial Transaction Tax

A financial transaction tax or stock exchange turnover tax levies a particular percentage of the selling price as a tax on every transaction. Alongside the obvious fiscal motivations, a financial transaction tax, stock exchange turnover tax or Tobin tax (on currency trading) also seeks to discourage transactions that serve exclusively short-term speculation or the exploitation of the tiniest arbitrage opportunities. The aim is to create a situation where market prices are less subject to fluctuation and more reliably reflect the underlying values.

That can only be achieved if a financial transaction tax is introduced across the board internationally. Otherwise it will produce only a displacement of business to less regulated regions. So the introduction of a financial transaction tax needs to be pushed at least at the level of the EU, or even better at the level of the G20. It will also be necessary to largely block the possibility of avoidance via OTC trading, with obligatory settlement through organised and regulated markets and platforms.

From a fiscal perspective it must also be remembered that the financial transaction tax is always paid at the location, where the product is traded – i.e. the world's major financial centres (e.g. in Luxembourg for funds based there). It must, therefore, be ensured that the ensuing tax revenues are distributed fairly between the states.

Finally it must be noted that although a financial transaction tax can might help to restrain short-term speculative fluctuations on the international financial markets, that will not automatically lead to additional stabilisation of the banking sector.

Despite these obstacles, Germany should energetically advance the debate about introducing a financial transaction tax on international basis or at least on EU-level.

¹ In economic theory external effects arise where the individual economic subject fails to take into account all the costs (negative external effects) or the entire benefit (positive external effect) of his actions. From the perspective of the welfare of society as a whole this leads to a suboptimal allocation: in the case of negative external effects there will be *too much* of the activity, while in the case of a positive external effect there will be *too little* of the activity (because the actor is unable to secure the entire benefit for himself). The idea of the Pigovian tax (or Pigovian subsidy) is to fill precisely this gap and force the individual to take into account all the costs and the entire benefit of his actions. If successful, Pigovian intervention rectifies market failure by preventing the divergence of individual and collective rationality.