

Regulation and supervision in times of financial market crisis

Position paper of Munich Financial Center Initiative (fpmi)

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After persisting during the previous months, the crisis roiling financial markets was dramatically exacerbated by September 2008's collapse of Lehman Brothers. The measures immediately enacted to restore players' trust in the system were requisite and appropriate. Now required is the learning of the proper lessons from the crisis, as doing such will enable us to improve codes of regulation and systems of supervision on a lasting basis. Issued by fpmi, this paper presents the fruits of national and international-level deliberations, and delineates those measures which the initiative views as being the most important.

- **Valuation and accounting in accordance with the IFRS**

Capital markets' ability to function is predicated upon companies' balance sheets presenting risks being borne in a way ensuring accountability, clarity and comparability. This mandates that the disclosure of risks be done in a single way throughout the world. Currently-applied methods feature a limited reporting of involvements and their qualities. Valuations of inventories of risks vary greatly on company-by-company and country-by-country bases. These variations have given rise to considerable uncertainties on markets.

Another factor giving rise to difficulties of application and to the accompanying failure to assure accountability has been the employment of fair value accounting in the valuation of illiquid financial instruments. In a countervailing development, the use of mark-to-market principles of valuation has required financial players to perform major-sized and rapid write-downs of their portfolios. This has especially applied to those structured products whose market value has been replaced by prices resulting from fire sales. Prices determined by using figures resulting from forced liquidation or from stress sales do not reflect the products' fair values. These facts speak against the application of in-market transactions in the determination of asset value. A better approach for illiquid financial instruments for which the application of a strict method of market valuation would lead to a value not making any economic sense would be to apply the discounted cash flow valuation method. This process first values the asset by using the flows of payment expected to materialize, and then discounts the resulting sum down to the date of valuation by using a risk-adapted rate of interest. This process has to be transparent. The utilization of best practice guidelines will improve the quality of the models employed. This, in turn, will enable the reporting of the value which actually exists. The alteration of IAS 39 (applying to methods of accounting) enables financial instruments which are now to be held as investments to be reclassified, should certain requirements be met, from being assets to be valued at fair value to those valued according to net procurement costs. The only products not permitted to be reclassified are derivatives. This alteration is designed to preclude the performing of write-downs exclusively occasioned by drops in market values, and thus not resulting from a prolonged worsening of creditworthiness. This altera-

tion takes into account the fact that a valuation of a stock of assets at net costs of procurement (pertains to the IFRS categories of loans and receivables and of assets held to maturity) or at fair value and in a way not impacting upon earnings (IFRS category of available for sale) are permissible.

The “once impaired, always impaired” regulation currently applied to equity instruments categorized by the IFRS as being “available for sale” leads to inequitable treatment of equity vs. outside capital instruments. This bias has no factual or technical justification. This regulation stipulates that all equity instruments which have already been written down in a way impacting upon earnings have to be subjected to further write-downs upon each value impairment (drop in share value) - even in those cases in which this drop may not be lasting. The reporting of impacts upon earnings arising from short-lived drops in share prices flies in the face of the clarity of compilation of accounts required by the IFRS. For that reason, this regulation should be rescinded. This would represent a further step towards removing the barriers between the IFRS and US-GAAP.

To preclude distortions of competition, the thrusts of these regulations have to apply equally to banks and insurers - and have to take into account the special features associated with each of these sectors. A further requisite move would be for national-level supervisory bodies to work with the EU’s level 3 agencies in fostering an application of the IFRS which is easier to understand and follow, and which is used throughout Europe. Differences between the IFRS and US-GAAP representing potential competitive disadvantages for European companies have to be eradicated. A final point: the development of the IASB’s IFRS should not lead to a carve-out by the EU, as this would represent a divergence giving rise to an EU-IFRS.

A brief look at fpmi’s positions

- Impart greater accountability and consistency to the valuation of illiquid financial instruments (by publishing the processes of valuation employed), and especially as regarding off balance sheets SPEs (special purpose entities)
- Re-examine Basel II’s stipulations on the capital adequacy to be shown by non-balance sheet items
- Employ a single method to the disclosure of risks
- Use common business sense in recalibrating fair value accounting. Now permitted, the application of models-based valuation methods (as a substitute for valuations based solely on prices prevailing on markets) is associated with the clarification of two key issues:
 - o The formulation of an interpretation of the term “active market” capable of meeting the situation’s needs and serving as the essential precondition for the use of model-based valuations
 - o Determination of the rate of discounting to be employed
- Rescinding of the “once impaired, always impaired” regulation for equity instruments which the IFRS classify as being available for sale.
- For the EU to avoid, whenever and wherever possible, undertaking a carve-out of the internationally-applicable IFRS

- **Finanzagentur GmbH: a contravention of the principle of subsidiarity**

Many banks experience the financial market crisis as being that of refinancing. This fact makes the advertising campaign being undertaken by the German government's financing agency counterproductive. The campaign showcases the government's new offering - day bonds. These are designed to meet the needs of private investors. There are a number of cogent reasons why this issuing and the objective informing it - the government's wish to have a greater share of the market for consumer investors - is misconceived:

- Defeating of objective of maintaining a nation-blanketing supply of financial services

The state is driving non-state suppliers out of the market, even though the latter are responsible for assuring the nation-blanketing supply of financial services

- Distortion of competition

The agency has advantages of costs. Its pitch is indirectly based upon the putatively greater - as compared to those products offered by commercial banks - security of investment offered by banking with the government.

- Issues of European-level regulations:

Preferential treatment shown to Finanzagentur GmbH through the provision of state subsidies

Germany's Federal Court of Auditors issued in 2005 statements on the federal government's budgeting policies. These statements pointed out that there was no need for the financing agency to pursue or even expand its outreach to consumers, as these services were being provided on a nation-encompassing scale by the country's banks.

The financing agency's advertising campaign is giving the general public a counterproductive message. The campaign is exploiting its not being affected by the financial market crisis, and its corresponding ability to offer completely safe products of investment. This campaign is thus playing upon the uncertainties and even fears held by the general public as to the security and safety of the country's banks - and for the sole purposes of increasing sales of proprietary products! FPMI is not prepared to condone such courses of action.

- **Financial supervision in Europe / Improving the supervision of transnational banking and insurance groups**

The EU Commission has proposed the setting up of colleges of supervisors for banking groups which operate in two or more countries. As of this writing, nearly 50 of the continent's largest banks and other financial service groups would be affected by this regulation. These groups are now being supervised by national-level bodies. The EU's proposals foresee these colleges being comprised of those national-level bodies now engaged in supervising these groups. The colleges would be chaired by the body in which the groups have their headquarters. These proposals are basically a step in the right direc-

tion. The problem posed by such colleges is, however, that topics of key importance (capital adequacy, for instance) would require all of the bodies' reaching and enacting decisions. Such multiparty-dependent processes could lead to frictions and delays of operation.

The initiative views plans to reform the solvency regulations (Solvency II) as being an important step towards improving structures of supervision. In addition to creating rules more closely connecting the amounts of capital adequacy with those of risk (by also taking into account the risks arising from the objects into which the capital has been invested), Solvency II's thrust is the setting up of group-encompassing bodies of supervision for internationally-operating providers of insurance and of other financial services. This scheme gives the lead or group supervisor far-reaching powers. These extend to the foreign subsidiaries of the company being supervised.

FPMI views Solvency II as having an indispensable core: its replacing of a complementary approach towards the supervision of groups with one based on group-encompassing consolidation. The key advantage of the change: financial institutions would be provided with a single point of contact, one responsible for dealing with all supervision-related issues. This new structure of supervision would thus accord to those of the management running the companies being monitored. Insurance groups operating in the EU will experience this change as a substantial lessening of multiple reporting and of other national-based processes. This change will also boost efficiencies of capital, as it will enable insurance groups to realize those diversification effects which can be clearly proved.

- **Financial market stability: regulation of hedge funds and of short-selling**

In times of market normalcy, hedge funds enhance market stability. They do such by exploiting the opportunities arising from arbitrage. These, in turn, stem from imperfections of market operation. Such transactions reduce volatility and increase liquidity on markets. Hedge funds also serve as large-volume conduits for the transfer and allocating of risks.

In times in which markets do not function normally, however, hedge funds' operations--especially when they involve such misdeeds as manipulation of shares--can well pose a fundamental peril to markets. There have been cases in which hedge funds have launched rumors about erroneous valuations, so as to profit from the resultant drops in shares. Similar problems have been faced by financial institutions thought to be experiencing lacks of liquidity. Even solvent institutions can experience such problems when short-term financing falters. Short-selling can exacerbate such short-falls by increasing the downward pressures on share prices. This, in turn, impairs the securing of capital. The resulting situation of ever large-sized financial institutions' experiencing illiquidity stokes the volatility roiling securities exchanges, and hampers the reversing of a downward spiral.

Needed are thus regulations of lasting effect on the world's markets. These regulations should not impair per se the potentially positive effects of short-selling. They should, however, prevent manipulations inciting negative trends. These regulations could include the following measures:

- Generally-applicable ban on naked short-selling

- Setting up a level playing field - one in which hedge funds are subject to the same kind of supervision as investment funds,
- Mandatory capital adequacy requirements for hedge funds (limiting of leverage) based on Basel II
- Beefing up the rules designed to prevent the use of rumors to manipulate shares

To foster transparency and efficiency of capital market operation, these regulations should be accompanied by a disclosure requirement which is greater than the official one of 3%. This applies to all arrangements used in the direct or indirect acquisition, on a single or multi-issue basis, of shares or other securities in a company. This rule also applies to understandings leading to the assumption of ownership of such items. This obligation to disclose also has to encompass arrangements leading to the acquisition within two years of the rights to acquire such shares or securities, or to assume ownership of them.

This attribution should also be part of securities and takeover codes, so as to provide all investors with the opportunity of being accorded suitably large-sized premiums of transaction, and to avoid their suffering losses due to lack of transparency. All outstanding positions in a security or in derivatives are to be subject upon the reaching of a ceiling to a general and aggregate obligation to disclose. These disclosures are to be made to capital markets. Also to be disclosed to the company are the names of the holders of name shares. The Risk Limitation Act, which has been enacted to increase transparency, and which addresses these items, should be revised without delay. The Act requires a greater precision of formulation.

- **Rating process**

Rating agencies helped cause the financial market crisis by often awarding top ratings to structured products. These best marks for creditworthiness and investment security led investors to dispense with the conducting of their own analyses and to rely on the judgments of the rating agencies. In doing such, they failed to consider the facts that ratings' reporting impact is limited in scope and applicability. Increasing both requires imparting a new and great transparency to processes of rating and valuation, with this especially applying to structured products. A further move should be to beef up the penalties imposed on agency misdeeds, as well as those designed to prevent conflicts of interest. The way to do this is to remove incentives promoting mutual dependencies between agencies and issuers of paper. The International Organization of Security Commissions should be charged with the establishing of the requisite standards. IOSCO should stiffen and make compulsory the codes now complied with by the rating agencies on a voluntary basis. FPML also hails the initiative being undertaken by the EU's Commission. It foresees the certifying and monitoring of rating agencies' being undertaken by national-level bodies, or by a new, EU-level institution.

Externally-compiled ratings were and will be used by supervisory bodies and regulations as criteria of assessment. These practices mandate the ratings' evincing of the highest degrees of trustworthiness and quality. The proposed measures and the retention of the legal role played by ratings in the process of supervision should, however, not sap investors' willingness to undertake proprietary due diligence.

A brief look at fpmi's positions

- Improvement of the quality of the output of the rating processes and of the data inputted into them (→ revision and stiffening of IOSCO's codes / best practices regulations for rating agencies)
 - Differentiation of the ratings themselves (corporate bonds vs. structured products): greater amounts of information on risk categories (risks of default and market-incurred ones) and susceptibility of ratings to changes in underlying data
 - Beefing up of penalties imposed upon rating agency misdeeds (enforcement by a court of arbitration)
 - Alteration of incentive structures
 - Scrutiny of role played by ratings in codes of supervision
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- **Management of risk and liquidity**

Requisite is the further development of the management of risk based upon qualitative criteria and stress tests. This holds especially true for off balance sheet items, which have to be taken into greater account in risk management processes. Such items' being subjected to capital adequacy requirements - as foreseen by Basel II - would be an important step forward. Basel II's weighting of risks and factors of conversion are to be scrutinized. Should such be necessary, these regulations will be revamped.

The consigning of credit-incurred risks to special purpose entities gave rise to a lack of transparency of operation, and that, in turn, was a major cause of the financial market crisis, except in those cases in which the SPEs were fully consolidated into corporate accounts. This situation has led the EU's Commission to launch a fundamental revamping of the regulations applying to the bundling and securitization of credit risks. The core of this revamping is the proposal to require financial institutions undertaking securitizations to retain 5% of each item issued. The revamping also demands a greater breadth and depth of risk assessment procedures. Some parties are demanding 10% or even 20% rates of retention. These would be too high. FPMI welcomes these proposed regulations. These, however, should not be enacted unilaterally by the EU. To create level playing fields, these regulations are to apply to both European and American financial institutions. This, in turn, requires the USA's prompt changing of their position regarding Basel II, whose principles they have refused to accept.

Stress tests are based upon quantitative models. This fact makes it uncertain whether or not such tests are capable of depicting such extreme crises of liquidity as the one which we are currently experiencing, as the requisite underlying statistics simply do not exist. These facts impact upon the supervision of banks' liquidity. The current crisis has, in any case, given the banking sector every reason to examine its fundamental data and the functionings of its in-house models.

A brief look at fpmi's positions:

- Improve the transparency of structured securitizations (by standardizing the figures required as to the nature and quality of the underlying assets, and as to the consign-ment of risk)
- Comprehensive disclosure of extant risks
- Improve the structures of stress tests, and extend their range of application to group levels

Summation:

FPMI sees the need for a package of measures capable of remedying the lacks manifesting themselves in regulations and processes of supervision and having fostered the spreading of the financial market crisis. A number of efficacious initiatives have already been launched in this area. The entirely justifiable demand for a beefing up of the code of regulations should not, however, give rise to a sprawl of rules which saps the willingness to take risks, and which thus diminishes the entrepreneurial spirit. This, in turn, would be to the detriment of customers.