DIW BERLIN

8th ESDN Workshop "Financial Markets, Institutions and Policies in the Context of Sustainable Development – Dimensions, Issues and Actors of an Emerging Arena

Germany: The German approach towards financial markets and its relation towards sustainable development

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Brussels, November 23, 2012

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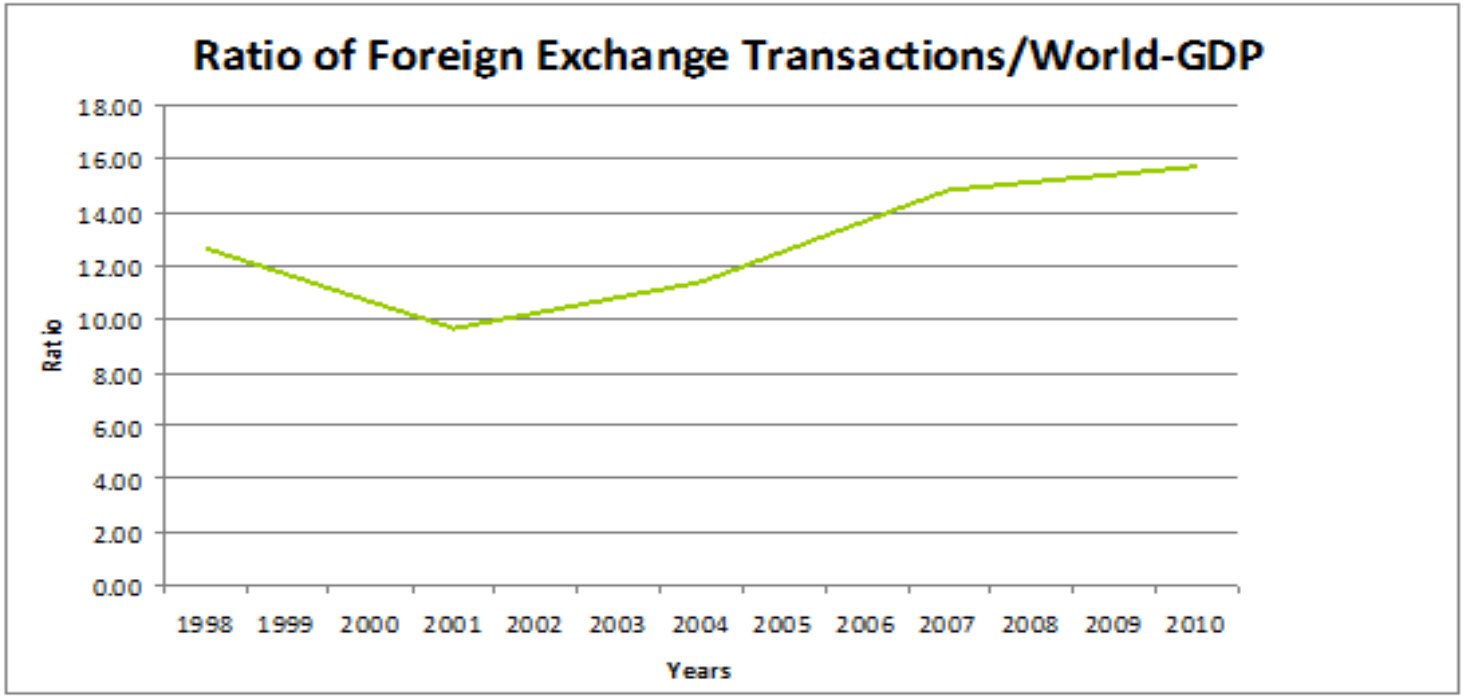
1

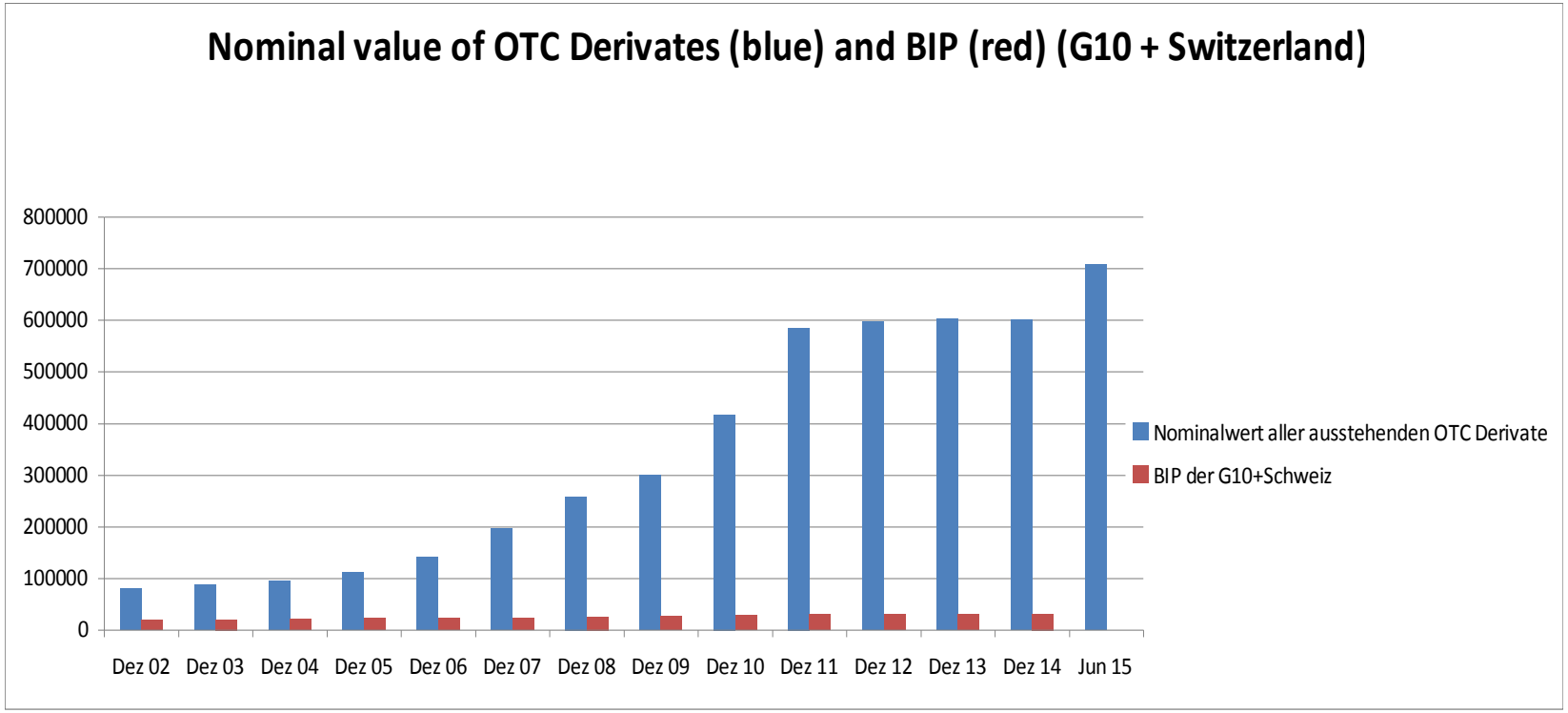
Preliminary remarks

Decoupling of Real and Financial Economy

Foreign Exchange Transactions have increased more than GDP (Trade Volume) despite the financial and sovereign debt crisis.

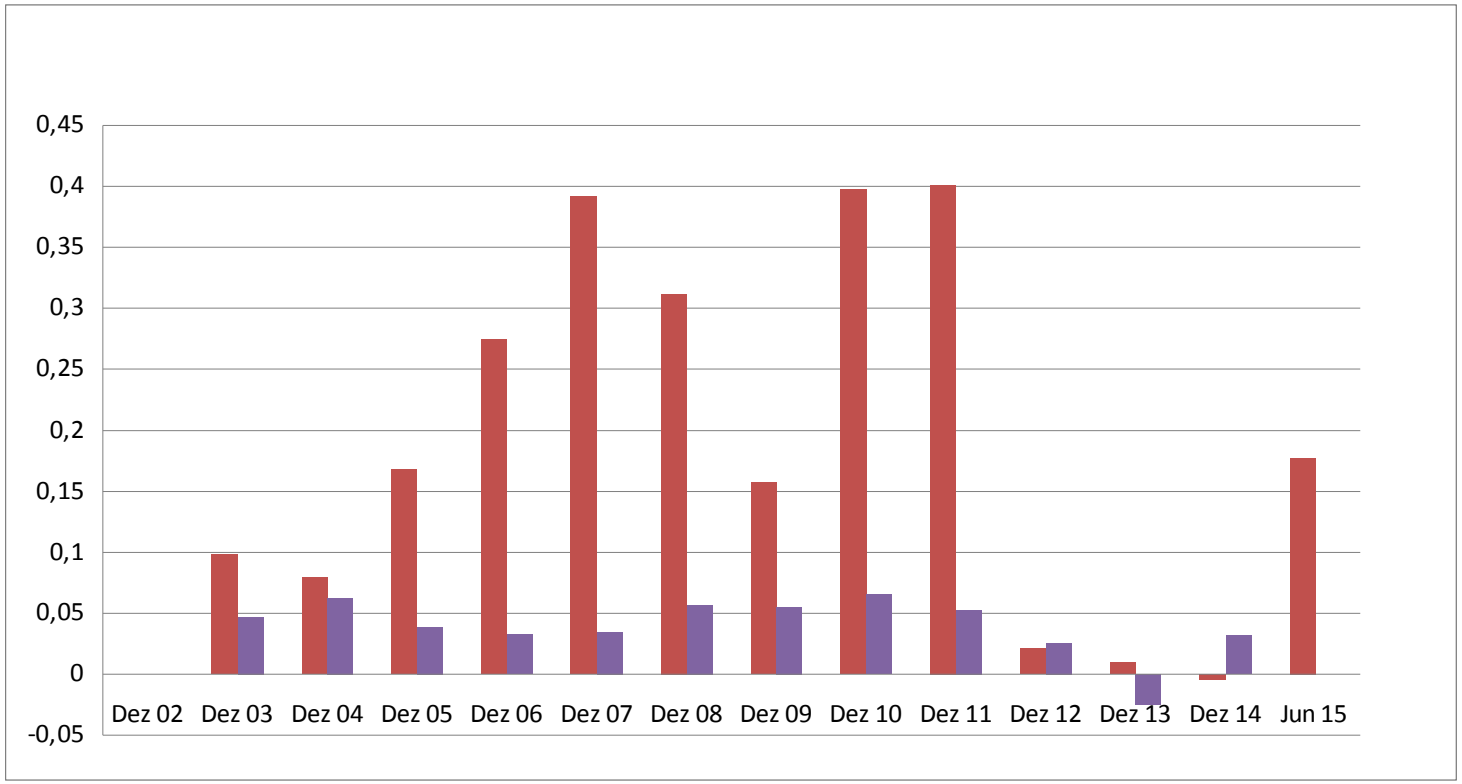


Another Symptom of Decoupling: Explosion of Outstanding Value of OTC



Symptom of Decoupling: Growth Rate way beyond .....

Growth rates (nominal value of OTC Derivatives and BIP)



2

Principles for Sustainability of the Financial System– Has Germany learned its lessons from the financial crisis?

2.1

Principle 1: prevent overusage of public good "Financial Stability" by implimenting an FTT

2.1 Principle 1: prevent over-usage by FTT

Stability in the financial markets is a public good

No exclusion, no rivalry in consumption

Financial markets driven by self-interested parties tend to overuse *financial stability* and are unable to provide stability by themselves. Only the state can provide financial stability.

Trading can be interpreted as using the public good "financial markets' stability".

FTT is a mean to prevent over-usage and to contribute to the financing of the public good.

2.1 Principle 1: prevent overusage by FTT

Status Quo: Germany is willing to introduce FTT

“Enhanced cooperation" when at least nine states come together in agreement.

Contribution to sustainability of financial markets depends on how the

tax looks like.

Important Principle: broad basis

No exemptions (for derivatives) to avoid tax arbitrage

Revenue?

2.2

Principle 2: Minimize Coordination Failure

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Micro level

Structured Products – Credit Derivatives (MBS, CDO, CDO^2, $CDO^{4)}$

Restructuring of debt by coordinated action of creditors impossible

- end of chain (creditors) and start of chain (households) are not identifiable
- unable to negotiate (many intermediaries in between, scarce documentation)

Retain a portion of the credit risk (loan) that is securitized

Enforce better documentation

Principle 2: Minimize coordination failure

Micro level

Structured Products – Credit Derivatives (MBS, CDO, CDO^2, $CDO^{4)}$

Status Quo in Germany

Retention Rule ***10%, starting in 2015 (EU 5%)***

Certification Agency for Financial Products *(-)*

Prohibition of re-securitization *(-)*

Principle 2: Minimize coordination failure

Micro level

Maturity mismatch (in off balance sheet vehicles SPVs)

Maturity mismatch requires a maximum of lender coordination

Coordination failure: liquidity crisis at maturity

Addition capital requirements for maturity mismatch

SQ: Basel III liquidity rules (liquid assets for 1 month, 1 year)

Capital requirement (-)

Principle 2: Minimize coordination failure

Macro level

Kind of “Beggar the neighbour policy”

- Deregulation (race for lowest standards)
- Race for system protection (e.g. Ireland)

Unilateral test of the whole system (Lehman insolvency)

Governing board

» Basic regulatory standards: **FSF (now FSB)**

» Cordination of rescue measures: **IMF**

SQ: Multiple bodies, unclear responsibilities, coordination at central bank level only

Principle 2: Minimize coordination failure

Macro level

National supervisors: not able to cope with cross-border financial conglomerates

Unified European Financial Market oversight

Synergy effects: Avoidance of double oversight, avoidance of ineffective competition in supervisory efforts at the European level

SQ: European System of Financial Supervision (EBA, EIOPA and ESMA),

no intervention rights

2.3

Principle 3: Put the right incentives in place

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Elimination of „temptation" to lower lending standards

Participation of originators in the default risk – retention at each stage of securitization

Managerial renumeration:

Distribute only the net amount of bonuses and penalties after 3-5 years

Shareholders should determine the renumeration scheme

No dividend ban on bonuses/dividends for ordinary banks

Link executive compensation to average salary desirable

Restrict the power of Rating Agencies

Commercial rating agencies (big three) without credibility
Obstacle to stabilizing the system

Non-profit rating agency (Europe) (Public or Public Private Partnership)

"Relief" of the regulatory requirements of public rating judgments

SQ: Registration and payment for supervision, prohibition of advice for rating customers, disclosure rating method (?), independent board members

2.4

Principle 4: Avoid excessive demands on the government

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Appropriate: strengthening the government's role
Regulator (setting of rules)
Supervisor (enforcing of rules)

Non-appropriate: increase of number of public banks

Landesbanken: 20 years of agony
Improvement can only be expected by structural change
Cleanup of the Landesbanken sector necessary

SQ: Seven independent Landesbanken after closing WestLB, some without a viable business model

2.5

Principle 5: Prevent “Charity Hazard”

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Business models of international financial conglomerates are backed by the tax payer (like Fannie Mae, Freddie Mac)

Incentive for risk loving behavior (moral hazard)

- Profits are private
- Losses are public

(Analogy: Flood victims that resist to buy flood insurance)

Remove the implicit government guarantees for large financial institutions

Introduce an EU-wide restructuring law and EU-restructuring funds

SQ: German restructuring law, German restructuring fund

2.6

Principle 6: Minimize Shadow Banking

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Shadow banking: outsourcing of risks from banks balance sheets

Turned out to be non-sustainable (non-renegotiation proof)

- Crisis: default risk returned into bank balances
- Liquidity risk returned (Bear Stearns Hedge funds, Rhineland Fund of IKB, Depfa)

Make mandatory: registration and authorization of off balance sheet vehicles by bank supervisers

Regulate and monitor SVPs as if no "outsourcing" occurred

SQ: Sector is growing, regulating of shadow banking sector still absent, European Commission checks different options for regulation

2.8

Principle 8: Put a greater emphasis on equity financing

2.7 Principle 8: Put a greater emphasis on equity financing

Main causes of crisis:

- lowering of lending standards and
- removal of any financial constraint

Dimension of crisis because of extensive leveraging

More equity in the private (real-estate) sector

Acceptance of the fact: financial constraints may protect the system

Leverage Ratio of 5 percent (plus crisis buffer) in the banking sector instead of risk weighted assets

2.8 Principle 8: Put a greater emphasis on equity financing

Leverage Ratio is consistent with sustainability

Figures of stress test 2011: average equity ratio for the ten largest German banks: 9.25 percent

Leverage ratio: 2.25 percent, ratio of RWA/TA= 0.25, leverage more than 40 times

In a bankruptcy, taxpayers have to back the entire bank balance and not just the risk-weighted assets

Low leverage ratio: high risk for lenders

SQ: In Basel III still dominant: equity ratio
Leverage ratio: 3 percent (2018), too little, too late!

3

Summary and Conclusion

3 Summary and Conclusion

Sustainable financial architecture is still to be achieved

Lack of central European Financial Market Authority

Capital requirement: risk weighted assets instead of complete balance sheet

Lack of a comprehensive financial transaction tax

Europe-wide insolvency law for banks is still not in sight

Granted it has been done much in the last four years and there are also some achievements.

But: there is still much to be done in the field of sustainable financial markets, for research and policy.

Thank you very much for your attention

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