II-6.17: Publication of the White Paper "Criteria for a workable approach towards bank levies and bank restructuring" by the Issing Commission on June 21, 2010

Wednesday 1 September 2010, by Lorraine Boris, Junior Editor

Translated Article

MAIN INFORMATION

The Issing Commission, also called the Advisory Group on the New Financial Order, appointed by Chancellor Angela Merkel and directed by Otmar Issing, published a White Paper for the Toronto G20 Summit on June 21, 2010, detailing the criteria for a workable approach towards bank levies and bank restructuring. The Commission recommends two new regulatory measures: the introduction of a Systemic Risk Charge (SRC), and the implementation of a transparent bank resolution regime.

CONTEXT AND SUMMARY

The Issing Commission has been appointed by German Chancellor Angela Merkel to work on the reform of the financial system after the crisis of 2007 and its aftermath on the global economy. The Group is led by Otmar Issing, advisor to Goldman Sachs, former member of the Board of the German Central Bank and member of the Executive Board of the European Central Bank from 1998 to 2006, who already worked on the future of financial supervision in 2008-2009: Otmar Issing was at that time one of the members of the European Commission's High Level Expert Group on EU Financial Supervision chaired by Jacques de La Rosière.

The four members of the Commission were asked to answer three questions:
1- How can banks be included in cost-bearing, in order that in the event of a future crisis, the costs not be borne entirely by the taxpayer?
2- How can the behavior of financial institutions be influenced so that banks assume more responsibility, especially as concerns banks bearing systemic risk?
3- How should those reforms be designed in order to encourage global growth?

In its Memo published on June 21, 2010, the Commission proposes the introduction of two new regulatory measures that should contribute to the containment of systemic risk: the introduction of a Systemic Risk Charge (SRC) and the implementation of a transparent bank resolution regime.

First of all, the Systemic Risk Charge should be a levy reflecting the contribution of each individual bank to the overall systemic risk, which is distinct from the institution's own default risk. It helps to internalize the cost of systemic risk, which heretofore borne solely by the taxpayer, by forcing banks to pay a charge depending on their contribution to systemic risk.

This proposition should be considered in the context of debates around other bank levies. It mostly constitutes Germany's answer to Gordon Brown's Financial Transaction Tax (FTT), Barack Obama's Financial Crisis Responsibility Fund and the IMF's Financial Activity Tax (FAT).

In this framework, the SRC expresses Germany's support for of an *ex ante* charge, a deliberate choice that enables to both the internalization of the social cost of systemic risk on the level of the individual bank, and the accumulation of a sufficiently large amount of funds in case of a crisis. More specifically, the SRC is a charge that should be imposed regularly, applying to all institutions that potentially contribute to systemic risk and/or that eventually would benefit from a rescue operation. Furthermore, the base for setting the charge would be variable rather than flat, reflecting the current assessment of the bank's contribution to overall systemic risk. The actual amount of the overall charge should also depend on the assessment of the systemic risk, and would be set at a high enough level to work as an incentive for a system-wide reduction of systemic risk. The sums accumulated should be immediately reinvested into the very financial institution that paid the charge. This way, the buffers against a systematic crisis are essentially stored at the level of the individual institution, thus reducing the possibilities for cross-subsidization between institutions.

Secondly, the Issing Commission underlines the necessity of enhancing the credibility of a systemic risk prevention system. That is to say that both bondholders and shareholders are convinced that in the event of a crisis, they cannot expect to be bailed out in any fashion. This requires a clear resolution regime, which enables each party to foresee the seniority of their debt. A proper resolution regime would not only bring with it a better allotment of rights in case of a future crisis, but it also is a prerequisite for market prices and corporate ratings to correctly reflect default risks.

Therefore, the Issing Commission proposes a resolution scheme that would rely on several features:

First, specific provisions for the quick resolution of a distressed financial institution should be incorporated in national legal frameworks. It should then define the adjudication between averting contagion and preventing creditor bailout. Indeed, both objectives are interdependent: because of the moral hazard, a system of creditor bailout, although efficient in the short term, brings a higher level of systemic risk in the long run. In order to stop this vicious circle, the Commission embraces the reestablishment of creditor responsibility. The following conditional bailout rule should also be tied to another rule that would increase the cost of outside bond financing by non-banks, thus restraining the size of the interbank market. And finally, the new resolution scheme should consider the possibility of central clearing of derivative contracts, in order to reduce the contagion risk stemming from pending derivative contracts.

BRIEF COMMENTARY

The propositions of the Issing Commission accurately highlight the necessity to introduce a charge on systemic risk and at the same time to implement a true international resolution scheme, for this only can guarantee that market participants can anticipate the risks that they are taking.

Interestingly, the Commission emphasizes that its conclusions aim at compensating the vagueness of the new proposed Basle rules on the calculation of systemic risk as a capital charge. Indeed, the Basle III rules solely focus on capital charges, while the Issing Commission suggests that such a charge should target the whole edifice of conditional equity capital, currently serviced as debt, but taken into account by banks as a true cost factor.

But what also comes out of this report is that the Issing Commission strongly advocates a deep reform of the financial system. It counters the argument according which no reform can be efficient without being implemented internationally - the famous "global level playing field" - since the financial industry can migrate to other financial centers where the regulation is laxer. If partially true, such an argument leaves out the hierarchy between the regulatory steps that should be taken in order to avoid the repetition of the recent crisis, and especially the bearing of the burden by taxpayers. The Basle process seeks a global level playing field on several points: the proper measurement and charging of the risk taken by the banks, and consequently, the provisioning of such risks by the banks, provisions which should also include an adequate amount of capital for unexpected losses. For these specific problems, the requirement of a global level playing field is, of course, essential. However, on the specific implementation of a bank levy such as the Systemic Risk Charge, an international harmonization, although very valuable, is not a prerequisite for its efficiency. Similarly, concerning bank resolution, transparency prevails over harmony. To this extent, the Commission’s conclusions are valid, since they pinpoint one of the fundamental pitfalls of the financial system that led to the global contagion: the lack of a transparent system of distribution of responsibility. Moreover, maintaining such a complex and finally opaque architecture operates as an incentive for higher risk-taking operations. Regulatory measures should focus on the distribution of responsibility to constrain the spreading of risks.

Finally, the Commission is very aware of the weight that both the Systemic Risk Charge and the implementation of an improved resolution regime would represent for financial institutions and finally on lending. However, they emphasize that "one cannot have deleveraging of the financial system and unchanged lending to firms at the same time" . The Commission is in favor of a high Systemic Risk Charge so that the system as such shifts from high to lower risk taking schemes. This stance strongly embraces a positive conception of regulation, underlining its strong incentive dimension, and can trigger a structural shift on a market.