

Press Points for Chapter 2:
Systemic Risk and the Re-Design of Financial Regulation
Global Financial Stability Report (GFSR), April 2010

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Key Points

- The recent crisis has triggered a flood of regulatory reform proposals to deal with systemic risks—the potential for distress in one institution to adversely affect others. However, details on many of these proposals are lacking.
- The chapter examines two of these proposals: a mandate for regulators to explicitly monitor systemic risks and the introduction of systemic risk-based capital surcharges that are commensurate with their contribution to systemic risk.
- The chapter argues that it is not enough to mandate that regulators “monitor” systemic connections, but that better tools would also be needed to combat systemic risks. Indeed, without such tools, regulators will have the tendency to be more lenient with systemic institutions in distress than others.
- While not necessarily endorsing the introduction of systemic risk capital surcharges, this chapter illustrates a practical methodology to compute such surcharges if this tool were to be used.
- The chapter also shows the importance of taking into account institutions’ cross-border linkages, hence requiring supervisors in different countries to collaborate to design such surcharges.

The recent financial crisis has triggered a rethinking of the supervision and regulation of systemic interconnectedness—the notion that distress in one financial institution will negatively affect others. Although a flood of regulatory reform proposals has ensued, there is considerable uncertainty about how they can be practically applied. Thus, the chapter aims to contribute to the debate on systemic risk-based regulation in two ways. It formally examines whether a mandate, by itself, to explicitly oversee systemic risk, as envisioned in some recent proposals in the euro area, the United Kingdom, and the United States is likely to be successful in mitigating it. As well, it proposes a methodology to compute and smooth a systemic risk-based capital surcharge.

Regulatory Architecture

The chapter argues that an important missing ingredient from reforms that mandate regulators to look at systemic financial risks is the analysis of regulators’ own incentives. This includes “regulatory forbearance”—that is, the regulator’s incentive to keep institutions afloat when they should be unwound—which will likely vary across different allocations of the regulatory functions.

The chapter shows how adding a systemic risk monitoring mandate to the regulatory mix without a set of associated policy tools does not alter the basic regulator's incentives that were at the heart of some of the recent regulatory shortcomings. Regulators often have the incentive to keep an institution afloat, even when insolvent, because regulators strongly dislike closing institutions under their watch, especially because in some cases, given enough time, an institution may get back on its feet. Therefore, in the absence of concrete methods to formally limit a financial institution's systemic importance—regardless of how regulatory functions are allocated—regulators may tend to be more forgiving with systemically important institutions compared to those that are not. This is because the systemically important institutions will have a more damaging effect on other institutions under the regulators' purview.

For this reason, it is necessary to consider more direct methods to address systemic risks, such as instituting systemic-risk based capital surcharges, applying levies that are related to an institution's contribution to systemic risk or, perhaps, even limiting the size of certain business activities.

Systemic-Risk-Based Surcharges

While not necessarily endorsing the introduction of systemic risk-based capital surcharges, the chapter presents a methodology to calculate them. Underpinning this methodology is the notion that these surcharges should be commensurate with the systemic interconnectedness of financial institutions. The chapter presents two approaches to implement this methodology:

- **Standardized Approach:** under which regulators assign systemic risk ratings to each institution based on their relative systemic importance and then assess a capital surcharge based on this rating.
- **Risk-Budgeting Approach:** which borrows from the credit risk management literature and determines capital surcharges in relation to an institution's additional contribution to systemic risk and its own probability of distress.

The methodology also presents a way to remove the surcharges' potential procyclicality—the propensity to increase in a downturn and drop in an upturn—a counterproductive attribute associated with most risk-based capital charges,

The chapter also shows the importance of taking into account the cross-border linkages across institutions that would influence such a charge, hence requiring supervisors in different countries to work together to design such surcharges.

Press Points for Chapter 3:
Making OTC Derivatives Safer: The Role of Central Counterparties

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Key Points

- Soundly run and regulated over-the-counter (OTC) derivative central counterparties (CCPs) will reduce counterparty risk among dealers and minimize the systemic risk associated with cascading counterparty failures.
- However, the costs to OTC derivatives dealers to moving contracts to CCPs is likely to be high as the amount of collateral that would need to be posed is large and hence the transition should be gradual.
- Given the global nature of OTC derivatives markets, close cross-border coordination of regulatory and supervisory frameworks is required to avoid regulatory arbitrage and mitigate systemic risk and adverse spillovers across countries.
- All OTC derivative transactions should be recorded and stored in regulated and supervised trade repositories, and detailed individual counterparty data should be available to all relevant regulators and supervisors.

OTC derivatives markets have grown considerably in recent years, with total notional outstanding amounts now exceeding \$600 trillion. During the financial crisis, the credit default swap market, a part of the OTC derivatives market, took center stage as difficulties in financial markets began to intensify and the counterparty risk involved in a largely bilaterally-cleared market became apparent. Authorities had to make expensive decisions regarding Lehman Brothers and AIG based on only partially informed views of potential knock-on effects of the firms' failures.

CCPs are being put forth as a way to make OTC derivatives markets safer, sounder, more transparent, and to help mitigate systemic risk. This chapter provides a primer on this topic, and shows that soundly run and properly regulated CCPs reduce counterparty risk among dealers and reduce the systemic risk associated with cascading counterparty failures. CCPs can also provide the opportunity to improve transparency because of their collection of information on all contract cleared.

However, since CCPs concentrate credit and operational risk related to their own failure, they should be financially sound, subject to prudent risk management procedures, and be effectively regulated and supervised. Moreover, given the global nature of OTC

derivatives markets, close cross-border coordination of regulatory and supervisory frameworks is required. This would help avoid regulatory arbitrage and mitigate systemic risk and adverse spillovers across countries.

Also, the benefits of central clearing at both the individual counterparty and systemic levels can only be achieved if a critical mass of contracts is moved to CCPs. In that regard, there remain some potential challenges, including enhancing the degree of product standardization and liquidity, and potentially large up-front capital and collateral costs in the form of initial margin requirements.

If dealers require extra incentives to move bilateral contracts to CCPs, the chapter puts forward the idea of a levy tied to the risks that their derivative books impose on their counterparties. A mandate to centrally clear standardized contracts is a less desirable solution because the need to post potentially large amounts of margin will be disruptive if done at once. Moreover, there are significant infrastructure development costs, including the development of information systems, new rules and procedures. However, if other incentives do not generate enough movement, a mandate may be necessary to overcome market participant fears of being first movers. Although it appears that derivatives dealers are indeed moving those contracts that can be cleared to CCPs, if authorities judge that a mandate is necessary, then it should be phased in gradually.

Policy proposals:

A number of policy proposals arise from the chapter, many of which are already in the legislative and regulatory pipeline. The key ones include the following:

- A global CCP oversight framework should level the playing field at a high minimum level, and discourage regulatory arbitrage. Authorities should have in place contingency plans and appropriate powers to deal with a CCP failure on a globally coordinated basis.
- Regulatory authorities should ensure that a CCP has adequate risk mitigation and management procedures and tools to protect the integrity of all related markets and the interests of its participants, and complies with the upcoming Committee on Payments and Settlement Systems and International Organization of Securities Commissions' standards for central counterparties when issued.
- For each jurisdiction, there should be a clear legal basis that assigns a lead authority to regulate CCPs, in order to ensure effective regulation and oversight. For systemically important CCPs the lead regulator should be a systemic risk regulator.
- Central banks should put in place the ability to supply emergency liquidity to systemically important CCPs in cases of extreme liquidity shortages.

Press Points for Chapter 4: *Global Liquidity Expansion: Effects on “Receiving” Economies and Policy Response Options*

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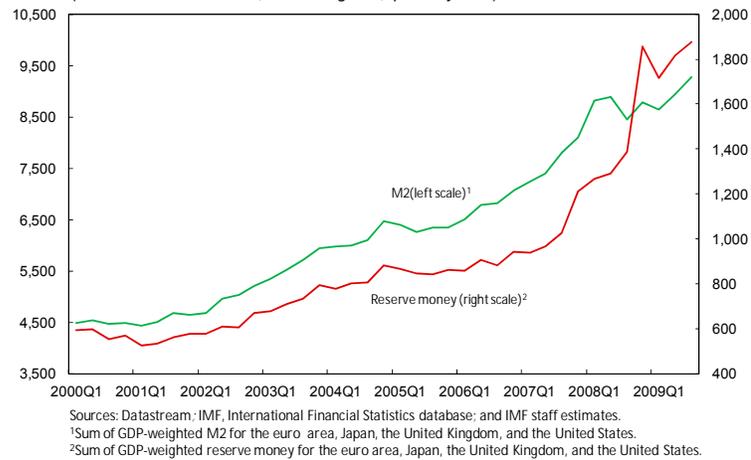
Prepared by Effie Psalida, Annamaria Kokenyne, Sylwia Nowak, and Tao Sun

Key points

- The transmission of abundant global liquidity to economies with higher interest rates and stronger growth can pose policy challenges. Although the benefits of capital inflows are manifold, sudden inflow surges may lead to inflation and asset price bubbles.
- The chapter finds that global liquidity pushes up local equity prices and lowers real interest rates in receiving countries, typically by more than domestic liquidity, and that more flexible exchange rates can dampen such effects.
- Liquidity receiving economies have a number of policies with which to respond to capital inflow surges. These are primarily an appropriate mix of macroeconomic policies, including a more flexible exchange rate when conditions permit, as well as reinforcement of prudential regulation.
- When these policy measures are not sufficient and capital inflow surges are likely to be temporary, capital controls may have a role in complementing the policy toolkit. While the evidence on the effectiveness of capital controls is mixed, they can lengthen the maturity of some types of inflows.
- Even if capital controls prove useful for individual countries in dealing with capital inflow surges, they may lead to adverse multilateral effects by encouraging capital controls in other countries.

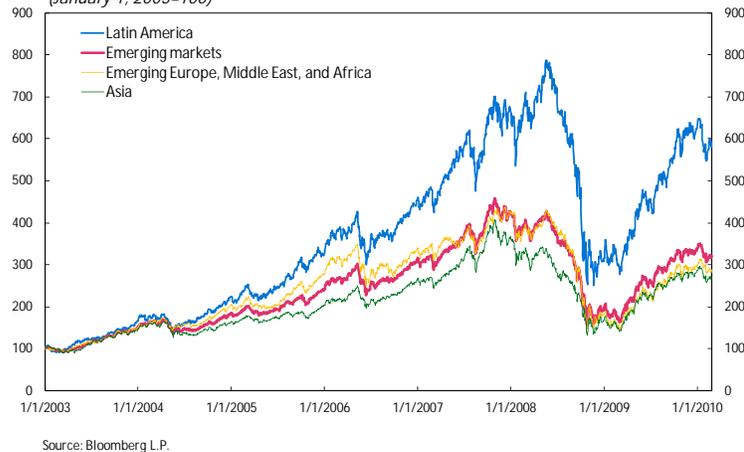
This chapter assesses the transmission of abundant global liquidity and the accompanying surge in capital flows to economies with comparatively higher interest rates and a stronger growth outlook. It finds that, additional to domestic liquidity, easy monetary conditions in the G-4 (the euro area, Japan, the United Kingdom and the United States) may pose policy challenges to liquidity receiving countries in the form of appreciation pressures and rising asset valuations (Figure 1).

Figure 1. Global Liquidity
(In billions of U.S. dollars; GDP-weighted; quarterly data)



The chapter analyzes and finds strong links between global liquidity expansion and asset prices, such as equity returns, as well as official reserve accumulation and portfolio inflows in the liquidity receiving economies (Figure 2).

Figure 2. Emerging Markets Equity Indices
(January 1, 2003=100)



There are a number of policy options available to policy makers of receiving economies in response to surges in global liquidity and capital inflows. The menu of policy responses for mitigating risks related to capital inflow surges includes the following:

- a more flexible exchange rate policy, in particular when the exchange rate is undervalued. The analysis shows that a floating exchange rate provides a natural buffer against surges in global liquidity and ensuing valuation pressures on domestic assets;
- reserve accumulation (using sterilized or unsterilized intervention as appropriate);

- reducing interest rates if the inflation outlook permits;
- tightening fiscal policy when the overall macroeconomic policy stance is too loose; and
- reinforcing prudential regulation in the financial system.

If conditions allow, liberalization of outflow controls can also prove useful. The appropriate policy mix will depend on country-specific conditions.

When these policy measures are not sufficient and capital inflow surges are likely to be temporary, capital controls may usefully complement the policy toolkit. However, more permanent increases in inflows tend to stem from more fundamental factors, and will require more fundamental economic adjustment. Well-formulated macroeconomic policies throughout an economic cycle can help lessen the affects of both surges and abrupt withdrawals of capital inflows.

The evidence on the effectiveness of capital controls is mixed. There is some indication that controls can lengthen the maturity of certain types of inflows—although they do not reduce the volume of inflows—and create greater room for the use of monetary policy independence. The chapter outlines some country case studies to highlight those types of capital controls that have and have not been successful in the past.

Even if capital controls prove useful for individual countries in dealing with capital inflow surges, they may lead to adverse multilateral effects. The adoption of inflow controls in one country, if effective, can divert capital flows to its peers, prompting the introduction of capital controls in those countries as well. A widespread reliance on capital controls may delay necessary macroeconomic adjustments in individual countries and, in the current environment, prevent the global rebalancing of demand and thus hinder global recovery and growth.