ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Working Paper 125

April 2, 2009

MACROECONOMICS | FINANCIAL MARKETS | ECONOMIC POLICY | SECTORS

Dr. Michael Heise, Wolfgang Ischinger

Rebuilding stable financial markets

Allianz

Working Paper No. 125

Rebuilding stable financial markets

AUTHORS:

MICHAEL HEISE
Tel.: +49.89.38 00-1 61 43
michael.heise@allianz.com

WOLFGANG ISCHINGER
Government Relations and
Public Policy
Tel.: +49.89.38 00-1 42 77
wolfgang.ischinger@allianz.com

1. BUILDING A STRONG FINANCIAL SYSTEM

The financial crisis marks the beginning of a new era on financial markets. Massive change has set in. This creates the opportunity to rebuild a strong system that operates on a sufficient capital base, where the risks accumulated in financial institutions balance sheets correspond to their risk-bearing capabilities, where corporate behavior is aligned to long term return incentives instead of short term leveraging and speculation and where investors and borrowers can count on long-term stability and are advised in their best interest. Business models will have to change, we need better regulation and more effective international supervision, with a holistic view on risks, combining micro- and macro-prudential perspectives.

In the end we should strive to create financial markets where

- Consumers are financially literate and making independent decisions on their financial needs, choosing from a wealth of solid and comprehensible financial products for saving, financing and risk management.

- Corporations have sufficient access also to long-term financial funds and can draw on proven instruments of risk management to shield them against various calamities and financial risks.

- Institutional Investors are capable of analyzing the inherent risks of their portfolios based on concise information on the financial products they buy; if using external expertise such as rating agencies they understand their models and underlying assumptions.

- Financial Service Providers operate under prudent supervision and are able to absorb risks on behalf of their customers; they strive to develop a business relationship into a long-term partnership by offering high quality advice and transparent products.

- Governments concentrate on setting an internationally agreed regulatory framework and need not interfere into the businesses of banks and insurers.

Such a strong financial system is the prerequisite for necessary social security system reforms. Despite the current crisis governments must not forget their duties to continue solving long-term concerns regarding our social security systems caused by demographic changes. Retirement provisions, health and care systems need further reforms leading them into durable and sustainable remedies. We should not lose sight that a sound financial system is the necessary prerequisite to rapidly arrive at these necessary reforms and practical solutions for the benefit of a majority of citizens. Insurance companies are already considered as trusted partner in this respect. Most insurers have only suffered limited impact by the financial crisis and are willing to extend this partnership.

However, building the bridge from today's shattered markets to such a system requires concerted action by all relevant players. Short-term stabilizing measures as well as medium-term reform are equally important.

2. RESTORING THE FINANCIAL SYSTEM TO HEALTH AND STABILIZING THE ECONOMY

Markets and the wider economy are in dire straits. They are being clobbered by a disastrous loss of confidence and are firmly in the grip of deep uncertainty. Investors are fleeing into the safe haven of the big government bond markets; private demand is plummeting. Stabilizing the financial system and stopping the free-fall in demand is a herculean task. At the moment, it looks as if policymakers are up to the challenge: They have acted boldly, easing (unorthodoxly) monetary policy, injecting public funds into banks and boosting fiscal stimulus. Much has been done, but the deep global recession has not yet been stopped, and the process of restoring the financial sector to health will be long and arduous.

National rescue packages and fiscal stimulus programes have been without alternative, but public coffers have been stretched to limit and long-term consolidation necessities are evident. Also efforts should be made to co-ordinate the diverse national financial measures in order to avoid moving into a consolidated, but less international financial landscape, as governments try to protect national interests first.

Any resurrection of protectionist instincts – especially in Europe's already highly integrated markets – could prove disastrous. Given the traumatic experience of the 1930s, the risks of protectionism and economic disintegration are only too well understood. It would be a historic tragedy if this financial crisis were to jeopardize the process of ever closer economic integration which has brought prosperity to millions around the globe.

Therefore, the G-20 leaders committment to clearly reject protectionism and to seize the chance for a greater degree of international policy co-ordination is of utmost importance. Now is the time to forge a consensus on macro-economic principles towards a better balanced global economy by means of integrating emerging markets more strongly in international institutions such as the IMF and the FSF. And now is the time to improve macro-prudential surveillance in order to mitigate dangerous credit and asset market bubbles.

3. REBUILDING THE REGULATORY FRAMEWORK OF FINANCIAL MARKETS

Rebuilding the regulatory framework of our financial system has been the topic of many policy meetings in the past year and a half. Progress is there, but it should be accelerated. There is a wide-ranging list of actions on the table – most importantly concerning accounting rules, capital requirements and liquidity management. The amount of regulations will certainly rise. But we should be reminded by all the regulatory efforts (from Sarbanes-Oxley to Basel II) following the last period of turmoil from 2001 to 2003 that quality of regulation is much more important than quantity. Therefore, it is important to establish the most important principles for better regulation in the present situation. We propose five quality checks that should guide the reform process:

- Comprehensiveness: no financial institution or market operating in the shadows
- Counter-cyclicality: rules that stabilize and mitigate herd behavior

- Principles-based regulation: establishing robust processes and governance
- Internationality: common rules and supranational supervision of global players
- Holistic regulation: creating micro-macro-prudential supervision linkages

Comprehensiveness

Transparency is the key for maintaining market confidence and for crisis prevention. The lack of information about over-the-counter-trading of financial derivatives, market segments such as "shadow banks" (structured investment vehicles, conduits) or hedge funds played a major role in the accumulation of financial risks. Supervisors were not fully aware of the extent, the interconnectedness, and the systemic risks emanating from that corner of financial markets.

Regulators and supervisors need to address that opacity. A reasonable first step, already proposed by the Issing commission, could be the setting up of a solid information base capturing global financial exposures and shedding light into the whereabouts of credit default swaps, collateralized debt obligations and other "toxic" financial instruments. The information of such a global data base could then be put together in a "global risk map" displaying financial links among systemic financial institutions as well as important risk drivers such as asset price changes and yield spread dynamics. Financial institutions such as hedge funds that so far eluded supervisors' scrutiny have to be included in such a global data base. Further steps to raise the level of transparency could include the standardization of contracts of derivatives and the creation of centralized clearing platforms.

Moreover, regulators and supervisors should take steps to restore quality and confidence in the reliability of credit ratings, of which issuer ratings had not shown the same weaknesses as structured finance ratings. Despite many criticisms, credit ratings seem to have even gained importance in the present downturn. Capital requirements of financial institutions and corporate funding conditions on capital markets decisively depend on issuer ratings. Investors continue to depend on ratings despite the increasing importance of own analytical capabilities. Therefore, the work of rating agencies should in future also be subject to high regulatory standards, based on the major international code of conduct for credit rating agencies of the International Organization of Securities Commissions (IOSCO). There should be an international institution enforcing these rules.

Counter-cyclicality

Our regulatory framework has become strongly pro-cyclical by the general introduction of fair value accounting rules as well as a shift to risk-based capital requirements.

Risk based capital requirements allow banks to reduce the amount of capital against existing loans during an economic boom as more optimistic assessments and improved ratings let them expect fewer defaults, and their risk-weighted assets decline. At the same time mark to market valuations rise due to booming asset prices and thus increase the capital base. Banks report large sums of excess capital which can be used for additional lending or, as we have seen, for gigantic takeovers adding fuel to the overall boom. Correspondingly, in times of recession, banking regulations force banks to set aside an ever increasing amount of capital

against existing loans as their complex models signal rising expected losses and their risk-weighted assets grow. Whereas capital requirements increase, the actual capital base shrinks as impairments on assets mount. Therefore, in line with the deteriorating economic outlook, banks start to cut lending even harder thereby fueling the crisis. A better regulatory approach would try to smooth capital requirements over the course of the economic cycle ensuring that capital buffers built up in good times are available to be drawn down in bad times. In that respect, the concept of "dynamic provisioning" implemented by the Spanish regulators should be considered carefully.

The concept of fair value measurement assumes an orderly transaction between market participants who are willing to transact. Distressed or forced liquidation sales are not orderly transactions. The strict adherence to observable market prices under such circumstances has self-destructive, pro-cyclical effects setting a downward spiral in motion.

Adjusted valuation models should be used for financial instruments in markets that are illiquid and distressed. When market data do not exist, estimates of future cash flows, including appropriate risk premiums, should be used to determine the economic value of the financial instrument. Moreover, reclassification of financial instruments should be permitted if market developments require the company's management to change the original business intent. Along these lines, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) should step up their efforts to develop global rules for fair valuing financial assets and liabilities in inactive markets in order to avoid pro-cyclical effects.

Moreover, mitigating pro-cyclicality should also take into account monetary policy. Monetary policy should give adequate consideration to the creation of financial bubbles and excessive movements in asset prices, both when formulating monetary policy and when communicating with market participants. This could make an important contribution to curbing pro-cyclical trends.

Finally, remuneration structures can have a pro-cyclical effect if they distort business strategies by encouraging a short-term profit maximization instead of sustainable profitability. Consequently, remuneration structures should create incentives geared to sustainable, long-term profitability.

Principles-based regulation

Rules-based regulation is unsuitable for monitoring quickly changing, international financial markets. Even a substantial increase in detailed rules and regulations cannot prevent the existence of loopholes. Moreover, the harmonization of the international regulatory framework requires principles-based rules which leave enough room to take account of national specificities. The desired greater coherence and convergence of the regulatory framework is easier with principles-based regulation.

A good example is risk management. Regulation and supervision cannot be restricted to evaluating the sophistication of risk models but need to check the processes and principles of corporate risk management, e.g. whether all relevant risk aspects are covered, whether risk managers have the necessary competences and early warning systems are in place. Companies have to treat risk management foremost as a management issue. The decisive thing is to introduce a strong risk culture

throughout the company and to make sure that the right procedures are in place. One of the lessons of the crisis is that not the instruments and models but the behavior of companies makes the difference. Even the most advanced risk management systems will remain toothless if they lack the backing of the top-management that ultimately has to decide to forgo short-term profitable business opportunities for the long-term stability and sustainability of the entire company. This shift "from bytes to brains" is inevitable as the crisis painfully revealed that the current generation of mathematical risk models for complex financial products, based on the normal distribution, have serious flaws. With their dependency on past volatility and market data, they were unable to "predict" extreme events, so called "tail risks" – which proved to happen in the real world much more frequently than in the models. The models worked with past financial market data that reflected the development from equilibrated markets into a boom period with low risk margins, rising asset prices and low volatility. They did not reveal the true risks. The strong trend towards time series models led risk managers to ignore economic fundamentals which signaled well before the crisis that some markets had indeed moved into the "danger zone".

Another example is liquidity risk management. As liquidity tends to dry up in times of market stress – exactly at the time when it is most desperately sought after – it is necessary to revise internationally consistent liquidity rules and practices that enable banks and other financial institutions to better withstand liquidity problems. The best way to achieve this is principles-based regulation. Extensive detailed rules and a quantitative approach do not always appropriately take account of the scale and type of different financial institutions' business and liquidity risk profile.

Internationality

The internationalization of regulation and supervision has been lagging the speed of globalization in the financial industry. Without an internationally harmonized regulatory framework, financial markets remain vulnerable to regulatory arbitrage, and financial institutions have an incentive to use regulatory loopholes. Moreover, uncoordinated regulatory initiatives can increase national fragmentation and endanger the achievements of open, liberal financial markets which principally promote higher growth through the efficient allocation of resources. Therefore, we need multilateral solutions for a common regulatory framework creating a level playing field.

More internationality is also needed in supervision. The proposed colleges of supervisors for global financial groups should be implemented as soon as possible; for a workable solution a clear allocation of responsibilities among the group supervisor and supervisors of subsidiaries in other countries is essential. The EU should continue along this path. Pan-European financial group supervision should be implemented at EU-level ensuring a single and consistent interpretation of its rules in all member markets. The proposal by the de Larosière Group – while stopping short of suggesting a single, pan-EU super-regulator – points the way: a European System of Financial Supervision with powerful coordinating bodies at EU-level. For the meantime, the swift upgrading of Solvency II towards the full group support model as initially drawn up by the European Commission would represent a huge step in the right direction.

Moreover, the financial crisis has demonstrated the importance of effective arrangements for cross-border crisis management. Markets may be globalized and

interdependent, but in the crisis, it was the national taxpayer who really mattered. It is indispensable to co-ordinate the diverse national measures to prop up the financial system in order to avoid dangerous side-effects. The new "Framework for financial repair and recovery" by the G20 is more than welcome. However, as many more financial institutions may "outgrow" their home markets in terms of balance sheets, a truly international regime of crisis management will become necessary. Therefore, given the move to international supervision, policymakers should introduce a well-designed, effective, and internationally consistent regime for dealing with weak or failing cross-border financial firms.

Holistic regulation

Preventing the accumulation of risks also needs stable macro-economic policies. Bubbles and credit booms do not happen without an economic cause. The actual financial crisis has its roots in the debt-addiction of the US and other deficit countries, fueled by low interest rates and booming real estate markets, on the one hand, the savings glut especially in emerging countries on the other. The threat that the correction of these global imbalances would occur in an eruptive way has overshadowed the global economy for years.

It is essential to intertwine such macro-prudential analyses with the micro-prudential surveillance of individual financial institutions. Supervision is not just about the trees, the individual company, but also about the forest, the wider market movements and the financial system as a whole. Systemic risks arise from the common exposure of many financial institutions to the same risk factors. Macro-prudential supervision therefore pays close attention to common or correlated shocks as well as feedback effects. Macro-prudential supervision should have an impact on micro-prudential supervision.

Therefore, regulators and supervisors should create suitable institutional structures to ensure that both prudential perspectives are adequately included. Again, the proposal by the de Larosière Group to create a European Systemic Risk Council (ESRC) looking at macro-prudential issues should be considered carefully. The success of such a new body will crucially hinge on the flow of information between the ESRC and the micro-prudential supervisors.

The G-20 meeting in London provides the unique opportunity to lay the groundwork for stable financial markets that support sustainable growth. However, not only a wide-ranging overhaul of the international regulatory framework is on the agenda. Policymakers and global business leaders urgently need to restore the ethical foundation of capitalism itself. We have to re-adjust the time horizon of our own interest and responsibility in line with the complex chain of reactions in an intertwined world. Self-interest that ends with the next quarter does more harm than good. Financial markets can serve stability and sustainable growth if all market players wholeheartedly embrace the long view – as insurers with their long-term investment policy naturally do. Long-termism is the crucial link between own interest, responsible behavior and social benefits.

These assessments are, as always, subject to the disclaimer provided below

CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Certain of the statements contained herein may be statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. In addition to statements which are forward-looking by reason of context, the words 'may, will, should, expects, plans, intends, anticipates, believes, estimates, predicts, potential, or continue' and similar expressions identify forward-looking statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (i) general economic conditions, including in particular economic conditions in the Allianz Group's core business and core markets, (ii) performance of financial markets, including emerging markets, (iii) the frequency and severity of insured loss events, (iv) mortality and morbidity levels and trends, (v) persistency levels, (vi) the extent of credit defaults (vii) interest rate levels, (viii) currency exchange rates including the Euro-U.S. dollar exchange rate, (ix) changing levels of competition, (x) changes in laws and regulations, including monetary convergence and the European Monetary Union, (xi) changes in the policies of central banks and/or foreign governments, (xii) the impact of acquisitions, including related integration issues, (xiii) reorganization measures and (xiv) general competitive factors, in each case on a local, regional, national and/or global basis. Many of these factors may be more likely to occur, or more pronounced, as a result of terrorist activities and their consequences. The matters discussed herein may also involve risks and uncertainties described from time to time in Allianz AG's filings with the U.S. Securities and Exchange Commission. The company assumes no obligation to update any forward-looking statement.

NO DUTY TO UPDATE

The company assumes no obligation to update any information contained herein.