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“Reform of the Global Financial Architecture”

– A banker’s perspective –

Lecture at the London School of Economics

March 19, 2009

Ladies and Gentlemen,

In two weeks, the leaders of the G20 will meet here in London to take measures to fight the worst economic and financial crisis the world has faced in over seven decades. Expectations are high – and, indeed, nothing but significant results will succeed in stabilising the global economy. At the same time, it is clear to all those involved in the process of implementing the lessons from the crisis – be they in the official or private sector – that the London summit will only be a small step on the long road towards a more resilient and stable financial system. In what follows I will outline elements of such a new architecture for financial markets, looking at regulatory measures as much as at action to be taken by the financial industry itself. Indeed, it is my firm conviction that we will only be successful if we combine the capabilities and resources of authorities and the financial industry.

[1. Efforts to redesign the regulatory system are underway – many useful proposals on the table]

Fortunately, substantial groundwork has been done ahead of the summit on April 2nd. Delegations were able to draw heavily on a number of excellent reports issued over the last 12 months or so and which literally contain hundreds of recommendations. On the part of the official sector, the most important documents have been the Action Plan issued by the Financial Stability Forum (FSF) in April 2008 and, building on the FSF's work, the G20 communiqué of November last year. Here in the EU, the de Larosière report was published recently and, building on this, the EU Commission has issued a Communication which charts the future workstream on financial regulation in the EU. The private sector

welcomes and essentially supports these proposals. They are appropriate measures to reestablish trust and functioning markets.

Simultaneously, the private sector has also presented a raft of proposals, chief amongst them the Report of the IIF's Committee on Market Best Practices published last June, the third report of the Counterparty Risk Management Policy Group and the influential Group of Thirty report, which carries particular weight as some of its members, such as Paul Volcker and Tim Geithner, now hold high offices in the Obama administration.

It's remarkable that, in terms of content, there is a large overlap between all these reports. While each of them naturally has a specific focus, they all essentially identify the same areas in which existing rules and practices have proven deficient and in need of reform. These include the areas of risk and liquidity management, transparency, market infrastructure, capital requirements and compensation practices.

It is noteworthy and, indeed, very welcome that there is a broad agreement between the official and the private sector on areas in need of change. This agreement not only reflects a broad consensus on the causes of the crisis; it is the fruit of efforts made in recent years to intensify the dialogue between the private sector and regulators. On the basis of this dialogue, a broad agreement has developed on regulatory philosophy based on the central tenets of principles-based and risk-based supervision. I am deeply convinced that we will only succeed in strengthening the financial architecture if we carry this effort forward in close collaboration using the respective strengths of both the private and public sector.

[2. But we cannot stop here. There are a number of areas where more needs to be done, where we need bolder approaches.]

Important though the proposals already under discussion are, we cannot stop here. The crisis has highlighted the fact that the existing supervisory and regulatory instruments, structures and approaches are not commensurate with the complexity of modern financial products and the international nature of financial markets. Consequently, there are several areas where more needs to be done, where we need bolder approaches.

Specifically, there is a lack of a comprehensive approach to controlling risk in the financial sector; there is too little transparency on risks and on the distribution of risk in the global financial system; there are deficiencies in the institutional structure for internationally coordinated action; and there are gaps in the instruments, legal prerequisites and processes for dealing with large, complex institutions that are in trouble.

Consequently, there is a need for a step change in our approach to regulation and supervision in several areas. Let me deal with these gaps and deficiencies in turn, starting with the lack of proper macro-prudential supervision.

[3. Macro-prudential supervision must become a central pillar of the supervisory system]

The current crisis has revealed a huge gap in the current supervisory system: All banks may individually satisfy regulatory rules – yet, huge systemic risks can build up unnoticed. The reason for this, of course, is that there is not enough focus on macro-prudential supervision. Incidentally, this gap is something the IIF has pointed out early on and it

is a welcome development that this notion is now being taken up at the regulatory level. There is, by now, a broad consensus that this gap must be closed. In fact, in both the US and the EU, proposals are on the table for establishing “systemic risk supervisors”.

But it is not enough to establish yet another committee. In other words, the establishment of systemic risk supervisors must have tangible consequences, because, otherwise, these new committees will remain empty shells. Concretely, I see four pre-conditions to prevent this from happening:

- First, all relevant parties must be involved, i.e. central banks, supervisors, regulators. In addition, a systematic dialogue with the private sector should be part of the modus operandi.
- Second, the macro-prudential supervisor must have full, direct access to real-time data, which is needed to assess systemically important financial institutions and infrastructures.
- Third, there must be political backing for the warnings and recommendations issued by the macro-prudential authority. It is not enough to be able to identify risks (which, incidentally, they were before the subprime crisis erupted); the responsible authorities and financial institutions need to be forced to react to them.
- Fourth, macro- and micro-prudential supervision must be intertwined: macro-prudential warnings must be translated into supervisory action for every bank in the course of the individual supervisory review process.

Incidentally, the new approaches to macro-prudential supervision in key financial markets such as the US and the EU must be complemented at the global level. The IMF and the FSF should play a central role in achieving this.

To stress the point again: In the private sector, we welcome the fact that the idea of stronger macro-prudential supervision is very much in fashion – but it will only be effective if it is translated into concrete action at the political and micro-prudential level.

[4. Supervision needs to be comprehensive and extend to all systemically relevant market participants and structures]

One of the reasons for the current crisis has been that major parts of the financial system escaped supervision. Hence, the lesson is that supervision needs to be comprehensive and extend to all systemically relevant market participants and structures.

Over recent decades, the complexity and size of the financial system have exploded. Many new actors emerged outside of the banking system. These new players provided diversity and helped boost liquidity. But many of these new actors were not just outside of the banking system, but outside of the regulatory system, too – this has now come to be known as the infamous “shadow banking system”. The existence of such a system is not acceptable.

We need to bring all important market participants and infrastructures into the system. Having said this let me stress that the emphasis must be on “systemically relevant” – i.e. we need to follow a risk-based approach to supervision where scarce supervisory resources are directed at the greatest risks.

Supervisors must have the right to designate institutions as systemically important and subject them to supervision accordingly. As one of those systemically important actors, Deutsche Bank understands and supports

that we are under special observation. This is commensurate with our importance and, in turn, it is in our interest that other systemically relevant actors are supervised appropriately.

As I indicated before, the group of systemically important actors does not only include large, complex, global banks, but also includes key market infrastructures, such as clearing and settlement systems and payment systems. We need to ensure that these systems are viable even if individual players get into trouble. Incidentally, to achieve this, it may be useful to make these business lines bankruptcy remote at the company level, too.

In addition, the group of systemically important actors includes non-regulated entities such as money market funds and SIVs. If these had adopted prudent liquidity, capital and risk management practices and were supervised like banks, the misguided developments thatled to the current crisis could have been avoided. As an aside, it is interesting to compare this supervisory gap with the case of hedge funds, which, to the surprise of many people, have not been the cause of the crisis. The UK's approach of requiring the registration of hedge fund managers, of subjecting funds to information requirements and of an intensive monitoring of the ties between hedge funds and their prime brokers has rightly been commended by the de Larosière report. I feel that this approach is a good example for other players to build on.

[5. Strengthening the market infrastructure is key to bolstering the resilience of the financial system]

Strengthening the market infrastructure will also be key to bolstering the resilience of global financial systems. Most of our market infrastructures date back to the times of nationally fragmented markets and to the days of unsophisticated, low-volume markets. Clearly, such structures are no longer adequate. And again, this is an area where only private-public sector collaboration can achieve results.

Major progress along these lines has already been achieved as regards the settlement of CDS contracts. This goes back to an initiative by the New York Fed, but the implementation has been a private sector effort in which Deutsche Bank, I am proud to say, played a leading role.

Similarly, great efforts are now underway to create a central counterparty (CCP) for CDS settlement. This will increase the system's resilience to the failure of any single market participant. I would venture to say that comparable efforts are sensible in the area of FX trading, where the Continuous Linked Settlement System, or CLS, has successfully been in operation for years. Again, this is an industry-led effort in which Deutsche plays a major role. Yet, although it has been around for years, CLS currently covers only about half of the global FX trading volume – clearly, we can and must do better than this.

To sum up: The financial infrastructure must be able to act as a shock absorber. It must allow the system to withstand the failure of major market participants. It is in our interest to work on this; indeed, we do so already, but we need to redouble our efforts in private-public sector collaboration.

[6. Infrastructure in a broader sense also needs to improve: transparency on complex securities markets]

When talking about improvements to market infrastructure we must not limit ourselves to clearing and settlement systems *per se*. There is also an infrastructure in a broader sense that needs attention. I am talking about the market infrastructure for the trading and pricing of complex financial instruments. This financial infrastructure has not kept pace with market developments: innovative structured products were introduced to the market, but many market participants lacked the ability to price these correctly and to monitor their inherent risk. This inability led many market participants who invested in these assets to rely on external judgements – specifically the opinion of rating agencies, rather than make their own judgement. Similarly, many investors lacked the capability to price these assets when markets became illiquid, because they neglected to develop the necessary processes and pricing tools in-house.

The markets for these products will only recover if investors regain confidence in their investment decisions. Markets and market participants need reliable price signals and a robust pricing infrastructure. For this to happen, we need to have a pooling of information on transaction volumes and prices. We also need to have transparency on the underlying of complex structured products.

Securities prospectuses must contain comprehensive and meaningful information that allows investors and supervisors to perform their own risk assessment of the underlying asset pool. It is ridiculous that prospectuses for such products run into 400 pages – but lack detailed information on underlying assets. Such comprehensive and meaningful

information should be publicly available. Monthly updates must be made mandatory and information must be provided online. Why not create a web-based solution that allows investors to get detailed information on performance and credit matrix based on a cash-flow analysis of underlying assets?

Again, the private sector should take the lead here. Such a reform programme would enable investors to make informed investment decisions and maintain active risk control, rather than engage in binary decisions (buy / sell). More sophisticated investor behaviour, in turn, would make markets less volatile.

To sum up this point: The lack of transparency on structured products created uncertainty and deepened the crisis once it started. These are signs of immature markets which lack the crucial infrastructure. It is in the interest of industry to rectify this.

[7. Banks’ risk management needs upgrading]

Of course, as, *inter alia*, the IIF report pointed out, deficiencies in banks’ risk management systems were not limited to the market segment of structured products. Rather, room for improvement exists in almost all areas of risk management – even though, of course, the extent of gaps varies substantially across banks.

High standards for risk management are the first line of defence. Such standards need to be developed by banks themselves. Where appropriate, they need to be enshrined in regulation; this is in the interest of every bank as we bear the costs of sub-standard risk management by other market participants who free-ride on the system.

The IIF, in its “Report on Market Best Practices”, has made comprehensive proposals for improving risk management. These comprise, to name but the most important ones, the institutional structures for risk management; the methodologies used for risk modelling including the routines for re-assessing these methodologies at regular intervals; the vetting of new products, and risk aspects of compensation practices. IIF member institutions have benchmarked their practices against these recommendations and are now closing gaps identified in this process.

This underlines that such “best practices” can work. In fact, a convincing piece of evidence for this are the IIF recommendations on liquidity risk management, published in March 2007. In fact, it is widely acknowledged that, had all banks implemented these, many liquidity problems could have been avoided in the recent crisis. I am happy to say that many of the recommendations contained in the report are based on Deutsche Bank practices. In turn, the Basel Committee has now built on the IIF recommendations in its latest proposals for liquidity management.

We welcome these proposals by the Basel Committee. Let me emphasise that there is an urgent need for an internationally harmonised approach to liquidity management. At the very least, there should be full harmonisation of liquidity rules at the EU-level. We must prevent a relapse into nationally fragmented liquidity regimes. This would make it impossible to run an integrated liquidity management at group level and would create pools of trapped liquidity in times of crisis.

[8. Capital is the next line of defence – and it needs to be strengthened]

If risk management is the first line of defence, capital is the second – and this, too, needs to be strengthened. Even if, as bankers, we would not think so ourselves, a clear message has been heard from investors: Banks individually and the financial system collectively will need to hold more capital in the future.

Against this background and based on the insights gained through the crisis, we support the Basel Committee's most recent proposals on reforming capital adequacy standards. The proposals will entail higher capital requirements for securitizations and the trading book. We believe these are appropriate adjustments – in fact, it may be interesting to note that our economic capital allocated to trading book assets has always been higher than the regulatory capital requirement.

Looking beyond the reform proposals already on the table, I see a need to make more fundamental methodological adjustments to the Basel framework. To be sure, Basel II did not trigger the crisis – but the crisis has revealed the need for major conceptual changes to the design of capital requirements. Specifically, it has become clear that the VaR-based calculation for trading book assets underestimates risk after a long period of benign market conditions. Consequently, the methodology will have to be adjusted to be commensurate with worst-case losses over a much longer time horizon. Periods of severe stress will also have to be taken into account.

Another issue that is perhaps just as fundamental that will also have to be addressed is procyclicality. Much has already been said about this, and to keep it short, I would just like to note that the dynamic provisioning concept seems to be a promising approach. Of course, it is

far from being the cure-all for procyclicality and many questions will need to be answered before we can implement such a regime. In particular, as dynamic provisioning affects the inter-temporal profile of a bank, banks will need to be very transparent about their provisioning policies, so as to enable investors to look through to the underlying profitability of the institution at any given point in time. But the underlying idea – building capital buffers in good times and being allowed to draw on them in times of turbulence – is a sound one. In any case, we need an intensive private-public sector discussion on this – much like the interaction we had when we put together Basel II.

[9. We need mechanisms – at the national and international levels – to deal with the failure of systemically important institutions]

Despite our efforts to make the financial system more resilient, there will still be cases in which financial institutions are at risk of failure. And, in principle, this is not a bad thing as risk of failure needs to remain part of the market system. Only the threat of failure will instil and maintain the necessary market discipline.

However, the Lehman Brothers case highlighted the fact that letting systemically important institutions fail is not an option with the current global financial system. As a result, governments have made a commitment not to let such institutions fail. Let there be no mistake: This was a necessary measure to restore confidence, but it also represents a step that creates severe moral hazard and is incompatible with market principles. It sends out the message that failure will only be a credible threat and, hence, exert market discipline, if it does not lead to a systemic stability risk.

Therefore, we need workable rules for dealing with failed financial institutions. By extension, there should also be mechanisms that allow for isolating large failed institutions from the system. This requires rules at the national level as well as the international alignment of corresponding rules to deal with the failure of cross-border groups. These would include rules on nationalization, the orderly winding-up of financial institutions, cross-border transferability of assets and insolvency rules.

[10. Large number of complex issues – which are made even more complex because they need to be dealt with in international collaboration. However, there is no alternative to doing so.]

Evidently, this leads to a huge catalogue of tasks. To complicate things further, all of these efforts must be pursued in an international context. A re-fragmentation of the financial markets cannot be allowed to happen. Market integration – for goods and services and for capital – is the bedrock of our prosperity. If accompanied by the appropriate safeguards, market integration is conducive to greater stability.

Against this background, it is welcome to see tremendous efforts are being made to ensure international coordination within the FSF, the G20, and other forums. But the risk of nationalism is clearly there and will only grow with the greater stake governments have now assumed in national banking systems. This will inevitably create a nation-state bias. Incidentally, this is why it is important that we devise credible exits strategies for the various state assistance measures.

In this context within the EU, I see a particularly important responsibility in safeguarding what has been achieved by establishing the single

financial market. We must not reverse this tremendous achievement. In creating supranational structures, the EU can and should go further than what is possible at the global level. As mentioned earlier, we believe this should also apply to the institutional structure of financial supervision. We need to build a truly pan-European system for micro-prudential supervision. The de Larosière report is a first step in the right direction.

Ladies and gentlemen, I would like to conclude with an important message: The economic and financial crisis poses huge and complex challenges to our economies and our political systems. Considering this complexity, it is understandable that those charged with finding answers have tried to reduce complexity and resort to answers that aim at safeguarding narrowly perceived national interests. Although it’s understandable – it is still a huge mistake. We must not allow a re-fragmentation of the financial system to happen, as this would leave us all poorer. Ultimately, this means that all reform efforts must be internationally coordinated. In this, the EU can and must go ahead. The financial industry, too, has shown that an internationally coordinated approach is possible, and we stand ready to collaborate with the authorities and other stakeholders in bringing our financial systems back to health and strength.