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Financial Crisis and Information Gaps

Comments on a Proposal by Otmar Issing and Jan Pieter Krahnen

Against the background of the present financial crisis Otmar Issing and Jan Krahnen, members of the expert commission advising the German government on issues relating to financial crisis prevention, have suggested the creation of a "global risk map" to be enhanced by a global credit register.[1] The following article comments and elaborates on this proposal and its practical implementation.

The financial crisis has revealed clear information and data gaps. This is evident when the risk situation and its development – especially those of systemically relevant banks operating internationally – are viewed from a more microstructural perspective. Moreover, the macroeconomic perspective has made it clear that there is little transparency when it comes to rapid changes in international transmission mechanisms.

Compared with the more microstructural debate, there is currently far less discussion on which information gaps must be closed especially from a mac-

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[1] Otmar Issing, Jan Krahnen: Why the regulators must have a global 'risk map', in: Financial Times, 19 February 2009; cf. also Ottmar Issing (chairman) et al.: New Financial Order. Recommendations by the Issing Committee, White Paper, No. II, February 2009, Preparing G-20, Center for Financial Studies, London, 2 April 2009 ("Report of the Issing Committee").

roeconomic perspective, e.g. because of changed transmission mechanisms. These have undergone a dynamic transformation in recent years, which is marked especially by financial globalisation, the institutionalisation of savings, more intensive use of the financial markets, the advance of new financial instruments and a shift of risk to households and enterprises. Both levels are closely linked to one another; however, this article focuses on the second level – the more macrostructural aspect.

The dynamic transformation of global transmission channels has helped ensure that "warning lights" have signalled tensions at the junctions of the international transmission channels, which were previously not – or insufficiently – recognisable. Early warning systems or soundness indicators were not reliable predictors of the crisis. The same applies to the speed at which the financial crisis spilled over to the real economy. In a very general sense, this raises the question as to the explanatory power of indicators and statistics with increasing globalisation.[2]

A major part of worldwide initiatives to strengthen the financial architecture and prevent financial crises has led to a number of proposals to improve transparency and data availability. At the same time, there is a lack of transparency about these proposals and existing initiatives. The different proposals must be systematised and an assessment made to evaluate the extent to which the priorities in terms of the data requirements determined by the users match the proposals for closing data gaps.

"Risk Map" Project of the Issing Committee

Against this backdrop, Issing and Krahnen, in an FT article, which reflects in brief the recommendations of the "Issing Committee",[3] recently proposed creating a global "risk map" and setting up a global credit register.

An important starting-point for developing a global risk map is the realisation outlined above that there is insufficient information on the interlinkage of big international banks and financial institutions, as well as on the risk distribution made via the financial markets and new financial instruments. The risk map aims at improving the basis for taking anticyclical measures; for this purpose, an appropriate global database of the international financial ties and the main risk factors is to be created.

Existing databases do not sufficiently meet these requirements. The following objectives are associated with the creation of a risk map: creation of a uniform database; estimation of systemic risk, enabling early and coordinated action.

However, these observations largely focus on banks. In many countries, large non-bank enterprises or institutional investors are affected in the same way. Moreover, it needs to be clarified to what extent this captures the risks for enterprises and households, which are at least as important for the escalation of the crisis and especially for its entrenchment.

According to the recommendations of the Issing Committee, the IMF is to prepare a conceptual proposal for creating such a database. This requires close cooperation with the Bank for International Settlements (BIS), the Financial Stability Board (FSB) and emerging market economies, which can help improve the data situation. Even though the proposal of a risk map has only been outlined, it is a step in the right direction.

- With regard to intermediaries, Issing and Krahnen recommend that supervision should focus more on systemic risk than on individual institutions.
- Early warning systems must contain much more reliable information on all markets, including derivatives.
- Setting up a global database would create a sound basis covering, in particular, global financial exposure. This should create more transparency on the cross-border linkages between large, complex financial institutions, about the risk allocation associated with Credit Default Swaps (CDS), and asset-backed securities.
- It should be supplemented by a global credit register: these are said still to have a predominantly national orientation.
- Moreover, Issing and Krahnen point out that there are no internationally coordinated initiatives.

The main "philosophy" of this proposal is in line with the stance taken, in particular, by Germany that no market, no financial instrument and no market player should be without regulation and supervision. It also makes clear, that this (more microstructural) risk map project would complement the global risk map model, which is more macroeconomic in nature.

[2] See also Hermann Remsperger: Globalisierung aus statistischer Sicht. Speech at the conference "Aussenwirtschaft in Zeiten der Globalisierung – Möglichkeiten und Grenzen der statistischen Messung," Wiesbaden, 22 April 2008, in: Deutsche Bundesbank (ed.): Auszüge aus Presseartikeln, No. 17, 23 April 2008, pp. 9-13.

[3] Otmar Issing, Jan Krahnen, op. cit.; and "Report of the Issing Committee".

In this case, improving the data situation does not mean creating a preferably comprehensive and costly network of data requirements for the economy or for individual sectors. The aim is, rather, to identify and close data gaps in a targeted manner, in a way that is particularly suited to meet the new challenges and help prevent financial crises.

Against this background, it seems imperative to tie this proposal into existing initiatives on broadening the database, especially since some of the existing initiatives also have a low degree of transparency.

Key Questions for Broadening the Database

While there may have been a lack of transparency in the past, an overshooting in the opposite direction should also be avoided. This is also the view held by the Issing Committee. The discussion of a large number of proposals on the selection of data requirements and priorities for closing data gaps can be directed by means of the following key questions.

- Which are the most important financial stability policy analyses, core issues and other activities? Which data are of increasing importance for more efficient monitoring and for surveillance?
- Which of these issues have been identified as very important, but cannot be addressed or discussed further owing to a lack of data?
- What data are available and what is the “remaining balance” of data gaps?
- With what priorities and in what time frame should these data gaps be closed?

The following should be borne in mind.

- Requirements in the area of monitoring are different from those in the area of analyses that are especially relevant to financial stability policy.
- Moreover, a distinction must be made between data that are to be surveyed once for the purpose of creating reports and those surveyed on an ongoing basis as part of official statistics.
- In addition, the closing of data gaps can also be categorised as to whether global (electronic) databases, e.g. based on the Centralised Securities Database being developed by the ECB together with several national central banks, are an option for which there are data gaps for several of the above-mentioned purposes and also constitute a tool for ad hoc analyses within the framework of financial stability.

In view of the rapid spread of the financial crisis and the unexpectedly sharp slowdown of global economic growth, the question as to what relevant information is missing for a better evaluation of the interdependency between the financial sphere and the real economy should be considered.

Identifying Data Requirements

According to this structure, those data requirements should be highlighted which have been called for by international experts on financial stability, in particular those who are involved in analysing global financial stability, developing vulnerability exercises for the assessment of country risks and assessing the stability of markets and intermediaries.

The conference “Financial globalisation, vulnerabilities and data needs” which was co-hosted by Deutsche Bundesbank and the German Federal Ministry of Finance in January 2008,[4] was structured on the basis of this procedure. This conference served the implementation of the G8 action plan for the development of local currency bond markets in emerging market economies and developing countries and its results were to be incorporated in the working programme of international working groups.[5] The participants were experts on financial stability and statistics from the IMF, the World Bank, the BIS, the ECB, the OECD, and other multilateral development banks as well as representatives from central banks and financial ministries from industrial countries, emerging market economies and developing countries.

Information gaps have been discussed and identified from the viewpoint of financial stability policy requirements. Of course, there is no room here to provide a complete overview of the range of proposals made by relevant institutions before and during the crisis. However, the data requirements can be roughly categorised into (1) stability of intermediaries, (2) stability of markets, and (3) country risk analysis.

Stability of Intermediaries

Cross-border linkages lack transparency: the financial crisis has shown, in particular, that cross-border linkages are more important – both quantitatively and qualitatively. The crisis was associated with a marked increase in intransparency regarding the risk expo-

[4] Documentation on this conference is available on the Bundesbank’s website at http://www.bundesbank.de/presse/presse_aktuell.en.php.

[5] For more information on this and on what follows, see Hermann Remsperger, Bernd Braasch: Priorities in broadening the database in emerging market economies and developing countries and organisation of the future work programme, in: Deutsche Bundesbank (ed.): Auszüge aus Presseartikeln, No. 8, 20 February 2008, pp. 9-12.

sures of big and globally acting banks. This is the main thrust of the proposal put forward by Issing and Krahnen. Moreover, risks to the stability of financial systems as a whole could not be evaluated due to weak transparency on off-balance-sheet activities.

Stability of Financial Markets

The financial globalisation process leads to a rapid transformation of financial structures and a shift in financial risk. Changes in the financial and market structures alter the "response pattern" of financial markets in the case of external shocks. However, data on the transformation of market structures – i.e. the change in issuer and investor structure, the use of new instruments etc. – for emerging market economies are often available only as a part of surveys and therefore not on a regular basis.

The market behaviour of global players – institutional investors and banks – is decisive for understanding market dynamics, contagions and spillovers. Without thorough analyses of the investment behaviour of large investors and of the central credit and liquidity management of large, internationally operating banks, no relevant progress can be made towards understanding and preventing financial crises. This applies especially to the rapid transformation of transmission channels of financial crises across markets and national borders. Better data on the capital flows (portfolio flows), which are triggered by financial non-bank enterprises and are the basis for better financial stability policy analyses and monitoring, are a high priority. The IMF's Coordinated Portfolio Investment Survey provides major improvements, but not to the required degree (low data coverage, different currencies etc.) The statistics are unsuitable for analysing the market behaviour of large institutional investors and banks.

New financial instruments: Financial innovations, such as structured products and credit default swaps, and the development of new markets have not only contributed to a broader allocation of financial risk, but were also a main determinant of financial globalisation and of the transformation of transmission channels. This process was especially dynamic in recent years. It is becoming increasingly important to intensify analyses concentrating on the implications of this development. This involves a special challenge regarding the associated data requirements, in particular with regard to innovative and complex financial instruments, securitisation instruments and instruments for shifting credit risk.[6]

The shift of financial risk increases the importance of balance-sheet approaches: In recent years, financial risk has shifted particularly to those sectors where data are unreliable in industrial countries and non-existent in emerging market economies – this applies especially to enterprises and households. Improving data coverage for these balance-sheet approaches is one of the major aims. Balance-sheet data for non-banks also constitute an important basis for estimating the vulnerability of economies and identifying the effects of financial crises on the real economy.

Country Risk Analysis

The vulnerabilities of countries, financial systems or systemically relevant institutions change very rapidly, as do the data needed for their assessment. The financial crisis has revealed or underscored a weakness in this area: numerous early warning systems and the use of financial soundness indicators are based on data and relationships that are still necessary but no longer sufficient to capture today's world.

Knowledge and evaluation of fiscal stability, the external balance, the high degree of price stability etc. – i.e. the traditional indicators – have proven to be necessary but not sufficient. This also appears true for balance sheet positions. Owing to the external shock on the international financial markets, countries for which the traditional indicators looked satisfactory have also been drawn into the crisis. Further analysis on the financial crisis also has to focus on the question to what extent the previous indicators must increasingly be supplemented by data from the financial markets which reflect this change.

In particular, more attention should be paid to which determinants regulate trends on the national and international financial markets and also cause the crisis to spread to countries with a stable macroeconomic framework. To what degree has the interplay between increasingly globally determined financial market developments and the corresponding national economies in industrial countries and emerging market economies changed? Before and during the crisis, *global* factors, such as high market liquidity and the large appetite for risk on the part of globally operating institutional investors, have had major, sometimes pre-

[6] Cf. Alfredo Leone: Statistics for the Balance Sheet Approach, IMF, presentation at the conference "Bond markets in emerging market economies and developing countries – Financial globalisation, vulnerabilities and data needs", Frankfurt am Main, 31 January and 1 February 2008.

dominant, explanatory power for the development of important *national* financial indicators – determinants which are unrelated to the fundamental development in the affected countries. Before and during the crisis, international investors rarely, if at all, differentiated between the fundamentals of the various emerging market economies.

Transformation and increased importance of the global financial market channel: the processes of financial globalisation, institutionalisation of savings, greater use of financial markets etc. have not only broadened the financial market channel, they have also made it much more complex. Analyses in this area must have priority, as must those focusing on the transmission channels from the financial sector to economic activity. The degree to which this area has experienced structural change in recent years can be seen in the fact that, in 2006 and 2007 alone, portfolio inflows to emerging market economies and developing countries increased by around 120%. What is even more significant is that the "other investments", which are not broken down further statistically, rose by over 400% in this period and have now been higher than the combined foreign direct investment and portfolio inflows to this group of countries. This is mainly due to lending by internationally operating banks, which have greatly boosted the development of the financial systems in the affected countries, but which, in times of tension in the financial markets, are forced to use the "global internal capital market" to adjust liquidity and shift credit activities. The relevant emerging market economies therefore run the risk of suffering an "imported credit crunch". As already mentioned, better data providing more information on this liquidity management and cross-border lending are a high priority.

Coverage by the global flow statistics, which might be able to provide some more information, is consequently insufficient. Existing statistics show too low a degree of disaggregation; in addition, more recent data are important. Further discussions should aim at clarifying to what degree the proposal to set up a central credit register would improve the data situation here – caught between transparency requirements, data protection in terms of individual data and reporting burden. It may be possible to overcome these tensions by a higher degree of aggregation.

These issues have been discussed, among other places, at the conference mentioned earlier, the results of which have contributed to the future programme of international working groups. This is particularly true of the Working Group on Securities Databases, which, against the backdrop of the G8 initiative on the development of bond markets in emerging market economies, was reconvened and is composed of the ECB, the BIS, the IMF, the World Bank and several national central banks, including the Bundesbank.

Initiatives for Closing Data Gaps

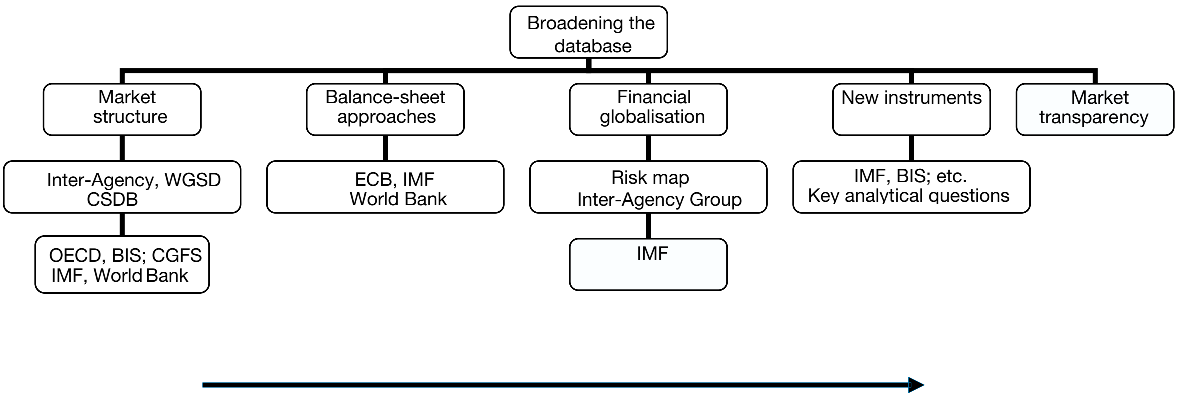
Of the large number of initiatives, in particular those of the BIS, the ECB and the IMF, to broaden the database and improve data quality and international comparability, the following deserve special mention as they are closely linked to the proposal put forward by the "Issing Committee". This applies especially to setting up global securities registers, which would form an important addition to the risk map and to the credit register, as they would simultaneously reflect the exposure vis-à-vis capital markets.

ECB Centralised Securities Database (CSDB): for several years, the European Central Bank and several national central banks have been working on setting up central securities database statistics. This expertise could be incorporated in the risk map project. In particular, this would involve checking to what degree the Centralised Securities Database, which might be used in particular for monetary policy purposes, is also suitable for financial stability requirements and how it may have to be extended, e.g. with reference to coverage of financial innovations.

Working Group on Securities Databases (WGSD): against the background of the G8 initiative to develop local currency bond markets in emerging market economies and developing countries, the Working Group on Securities Databases was reconvened. The WGSD is the working group that is in particular responsible for implementing the recommendation of the G8 finance ministers to broaden the database in the area of bond markets in emerging market economies. The WGSD would therefore be the group whose work could best be connected to the risk map project and the establishment of a central securities register.

Globalised Securities Database: however, it should be taken into account that setting up such a global securities register would require a significant amount of time. In the above-mentioned conference, discussions whether and to what degree the ECB's Centralised Securities Database can be a model or even the nucleus of a Globalised Securities Database generally came to a positive conclusion. However, the response was muted with reference to the large time requirements and the lack of data for the emerging market economies. Nevertheless, use could be made of the

Figure 1
Major Areas for Broadening the Database



expertise of the WGSD, the ECB and the Bundesbank, which is active in both areas.

Figure 1 shows in a tentative manner selected areas and some initiatives for broadening the database. Apart from a few reservations, most initiatives no doubt aim at improving the transparency of the market structure. These include reports and surveys, which reflect, for example, the changes in the weight of issuers and the shares of the respective investor groups and financing instruments etc. At the same time, these important initiatives aim at improving the international comparability of the statistics. These statements are particularly true of emerging market economies.

However, the chart of major changes in the financial markets below shows that the greatest analytical challenges relate to the implications of financial globalisation, new instruments and the improvement of market transparency. In the schematic presentation, data requirements therefore increase from left to right.

Further Criteria for Closing Data Gaps

A main criterion for closing data gaps is the degree to which the respective options contribute to shortening the time lag between identifying financial crises and closing data gaps – not least with reference to future financial crises. In particular, this requires three steps: (1) a more intensive ongoing dialogue between the users and the producers of the relevant statistics. (2) since prevention is of paramount importance, it is critical that an "evolutionary and preventive view", which also considers possible future financial crises, be increasingly adopted. (3) when creating global databases, the question should be raised as to how far they provide an analytical tool for the short-term assessment of future financial crises.

Role of the International Financial Institutions

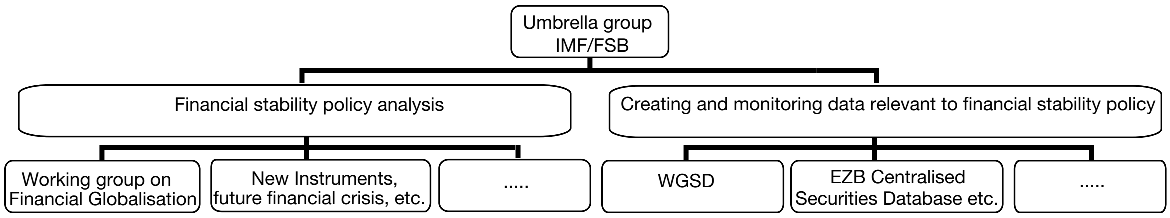
The G20 has granted the International Monetary Fund a leading role – in close cooperation with the Financial Stability Board (FSB) – in ensuring global financial stability. Owing to its broad membership, the International Monetary Fund has considerable advantages, especially in achieving greater transparency in the area of international financial linkages, identifying the accumulation of financial risk at an earlier stage and extending its analyses in the area of financial stability as well as in the area of financial and real linkages. Therefore, the focus is on monitoring and financial stability policy analyses.

Against this background, it is imperative that the international financial institutions – depending on their specific aims and comparative advantages – first themselves identify those significant tasks and information gaps which must be given priority with the aim of preventing financial crises and better understanding the transformations of transmission channels.

Organisation and International Distribution of Roles

The mandate of the previously mentioned WGSD is mainly improving securities statistics. These are important; however, financial stability experts have – as already mentioned – identified additional data gaps which they give a high priority to closing. The question therefore arises which institutions should close any other data gaps that are especially relevant from a financial stability policy perspective.

Figure 2
Organisation of Identifying and Closing Data Gaps



One conceivable solution would be to found an umbrella group, including the WGSD as well as other existing or newly created working groups that deal with the further – for instance analytical – challenges of broadening the database.

The creation of a working group at the IMF to implement the proposals put forward by Issing and Krahnen could boil down to such an umbrella group. Such a group could be responsible not only for creating the risk map – the scope and format of which still need to be specified more precisely – but also for extended requirements. Moreover, existing internal working groups should also be included in this structure, which conduct the discussion from the users' point of view. It could also contribute to channelling the "flood" of new proposals and working groups.

The Inter-Agency Group on Economic and Financial Statistics, which was established at the end of 2008, could play a role as part of such an umbrella group. It comprises representatives of the BIS, the ECB, Eurostat, the IMF, the OECD, the United Nations, and the World Bank. The group is chaired by the IMF. It has launched a new website covering economic and financial data of the G20 countries in April 2009.

This is an important step, but it should be emphasised again that improving the database requires an ongoing and preferably forward-looking dialogue between the experts who identify data gaps in the financial stability policy analysis and the data producers. It may also require a different organisational structure – one that better responds to the current global challenges and ensures transparency of the worldwide data initiatives.

In view of the tasks that the G20 has assigned, in particular to the IMF, in the areas of monitoring and surveillance, questions about financial innovations, possible future financial crises and data requirements will play a central role for financial stability. The same applies, for example, to the analysis of macro-financial linkages and the implications of financial globalisation, to name just a few examples. In the coming years, the Committee on the Global Financial System (CGFS) and the FSB may also deal with these central questions of financial stability.

It is important that any working groups in this area do not work only on a case-by-case, temporary basis focusing on tightly defined issues; an ongoing analysis and exchange of information with statistics experts is more important.

Participation of the central banks should be ensured in every way when allocating roles and creating such an umbrella group, also in the contributing subgroups, since the central banks are increasingly important for financial stability and must be integrated directly in the information flow, especially with reference to future financial crises. This would be an argument to give the IMF and the FSB greater joint responsibility.

The above-mentioned considerations show that the proposal by Issing and Krahnen could be tied into other initiatives and provide them with positive side effects. Possible objections regarding data protection and reporting burden may have to be considered if the IMF is to create a detailed concept. In any case, it will also be important to assess the balance between predominantly global and national transparency requirements.

The point is not to create a myriad of new data (even the critical question which data are no longer needed in today's world is allowed) and additional working groups, but to intensify a global, focused, forward-looking and ongoing process of assessing data and information requirements in the area of financial stability with a view to tackling the new challenges that have become virulent because of the crisis. This applies especially to the area of global monitoring and deepening financial stability policy analyses, which are at least as important as improving supervision.