



The paralysis of the interbank market is not receding and is weakening the banks and hindering the economic recovery

Despite the exceptional measures adopted at the end of 2008 (strengthening of banks' capital by States, State guarantees for helping

banks to find long-term resources, increase in the level of liquidity provided to banks by central banks), the interbank markets, guaranteed bank debt transactions and securitization operations have remained paralyzed, due to investors' lack of confidence in the financial institutions. More specifically, the banks, major players on these markets, are no longer lending to one another.

The situation of financial institutions is highly precarious. The ECB's support, provided on a short-term basis, only helps to meet banks' needs for cash created by the gradual repayment of their medium and long-term debt. This is gradually weakening their balance sheets by increasing costs and liquidity risks (short-term financing for assets with a longer maturity).

The few long resources available are potentially expensive. This is leading to an exceptional increase in the cost of refinancing conditions, which represents a major reason why banks are not passing on the central banks' base rate cuts. This situation is getting in the way of what is an essential economic revival.

Lastly, the increase in banks' capital requirements, resulting from the deterioration in their counterparties due to the recession, is contributing to reducing the economy's financing while increasing its cost. As a result, risk aversion leads banks to restrict credit distribution.

What sustains the mistrust of banks?

Over the last few months, the markets that normally cover bank financing have dried up as a result of the total lack of mutual confidence and the uncertainty surrounding counterparties' future losses.

This lack of trust stems from the opacity surrounding the risks taken on by each financial institution in terms of toxic assets, a lack of visibility over the nature and scale of the risks embedded in the securitized assets that the banks have had to include under their balance sheets (CDO, CLO, etc.), as those related to new problems coming to light (Madoff). This mistrust is reinforced by the economic crisis, which will result in deterioration in the quality of credit portfolios.

Adverse economic conditions and market dysfunctioning oblige banks to recognizing write downs as and when assets are devalued on the markets. This situation points to a gradual revelation of hidden losses which worries third parties and creates a climate of uncertainty and fear about the future.

The amount of provisions thus recorded does not reflect the effective impairment in the assets' values, insofar as the depreciation of market prices is partly due to the temporary lack of liquidity of these assets and the irrational risk aversion which is currently pervading markets.

Furthermore, the disconcerting discovery of toxic assets in various investment vehicles issued by banks (CDOs, cash management dynamic mutual funds, funds of funds) indicates that they are widespread outside the banking system and that their actual extent is difficult to assess, which is increasing the level of risk aversion.

At the same time, the diversity of the approaches used for restating assets in the accounts, which were recently allowed by the IASB and FASB, is sometimes suggesting a reduction of the comparability of financial institutions' balance sheets, this adding to the current lack of trust.

This is being compounded by the feeling among investors that financial institutions must be unwilling to fully externalize the potential loss included in the complex assets that they hold or which were initially located within ad hoc conduits.

Such an intricate situation can only be improved by a bundle of corrective measures. Not a single one could possibly be sufficient for markets to return to normality. Three different areas for action may come to mind and indeed are being explored. First, state intervention may support institutions to rebuild confidence. Second, portfolio composition or asset structure must be clarified and disclosed to the extent necessary. Third, some common method of valuation must be implemented.

Public intervention

Central banks have immediately provided banks with the necessary liquidity when they were unable to raise it on the money market. They have extended the list of eligible assets. Their action did avoid a number of difficulties but failed to restore normal market conditions. State intervention becoming necessary, it could take various forms, most of them having already been tested.

In the same vein, the ECB should also extend its financing facilities to medium term maturities. This would significantly contribute to reducing related spreads which are currently excessive.

¹ This Eurofi paper do not engage the Chairmen of Eurofi

The first possibility would have been to extend public support directly to debtors defaulting. For instance the Federal Government of the United States could have made it good for the insolvent borrowers of subprime mortgage loans, right from the beginning. This would have been less costly than the Paulson plan and might have avoided the systemic risk still pending. It was not considered as being non conventional, legally difficult to implement and entailing a high risk of moral hazard. It would have required an early detection of the spill-over effects of the real estate crisis which instead were underestimated.

Similarly, it may seem appropriate to build up a defeasance supported by public money. This was (rightly so) the basic idea of the Paulson plan, the TARC. It was soon criticized and the money was then used in a different way. However the Fed felt it necessary, at a later stage, to buy toxic assets from banks as collateral or to swap them against Treasury bonds. More recently, the view was put forward in various countries that the creation of a bank should be set up to collect bad assets from existing banks. This is precisely a defeasance technique allowing banks which balance sheets have been cleaned to inspire confidence and resume trading.

Governments preferred in general to recapitalize banks. No doubt that this was useful, but it did not avoid additional losses requiring additional support. These repeated contributions to banks own funds can only be unpopular and give the impression that the situation is not under control and that an endless process has started. The final outcome may be to fully nationalize the banks in trouble. These would benefit from the reputation of their State, which however is not without limit, as shown in some countries (e.g. Iceland). In addition this would create within the European Union a new situation not compatible with cross-border mergers and a further integration of the financial market, banking becoming a truly national business.

Some Governments asserted that they would fully guaranty either deposits or interbank transactions. These statements were seen by banking community as a political commitment more than as an operational arrangement. No window was open in any public institution for a compensatory payment in case of default. The promise went unheeded,

This catalogue leads to a few conclusions. State intervention cannot entirely solve the problem. Nevertheless it has been invaluable and must be carried on as necessary by various means in a pragmatic way. But it should be limited to what is indispensable, remain reversible and respect the principle of free trade and competition on which the development of the internal market was and still should be based. It would also avoid impeding national and cross-border processes of financial institution consolidation.

Improving banks' financial communications is necessary to restore confidence and is a precondition for any public intervention

This means that financial institutions of all kinds (banks, insurance companies, funds) could and would provide investors with credible and consistent information on their assets and the corresponding risks.

Strictly common specific asset naming system

First of all, it calls for a strictly uniform implementation of asset reclassifications. This mapping requires common specific asset naming systems created for this purpose. Although this approach is often considered to be too complex, it has already been launched close to one year ago by the Senior Supervisors Group², as requested by the Financial Stability Forum. The aim is to transform this collection of leading practices, published in April 2008, into a common nomenclature, which will need to be used systematically by all financial institutions.

This Senior Supervisors Group initiative identified the practices of 20 international banking groups, highlighting the need for banks to "communicate on their exposure to certain instruments that the markets consider to be high risk, (...) including CDOs, RMBS, CMBS, the various SIVs and the assets involved in leveraged transactions".

More specifically, according to the leading practices, the following details would need to be disclosed for each category of exposure:

- Total exposure, including off-balance sheet risks and confirmed refinancing lines
- Pre and post-hedging exposure levels, indicating the counterparties for these hedging operations
- Pre and post-writedown exposure levels
- Breakdown of exposure depending on the quality (tranches held – investment grade, high grade, mezzanine) indicating their current rating and the "vintage" of the securities held
- Underlying assets (asset type, end borrower location, average maturity, etc.)

Beyond these most troubled assets, in order to provide a total visibility in the context of the economic crisis, this nomenclature should also encompass traditional assets related to corporates, smes and consumers.

It would belong to the independent auditors to ensure the consistency of its implementation.

Such disclosure must be backed up with information and training campaigns, particularly for rating agencies and financial analysts, on account of their role in informing the investor community.

² The French, German, Swiss, British and American (FED, FED NY, OCC and SEC) banking supervisors are grouped together within the Senior Supervisors Group. "Leading_Practice_Disclosures": http://www.newyorkfed.org/newsevents/news/banking/2008/SSG_Leading_Practice_Disclosures.pdf

Highly consistent global valuation practices

Second, financial communication raises, today more than ever, difficult issues related to valuation practices, which need to be reconsidered in the light of recent events. These have shown that the concept of fair value applied by IASB to portfolio valuation could not satisfy financial intermediaries and creditors. Either there is a market and under current circumstances price volatility triggers random losses which induces corresponding capital needs, or there are few transactions if any. In the latter case, it is impossible to determine a value which fits with the needs of the various kinds of holders. It may be fair to value a given asset at zero for a short term creditor whereas it has a true value for a long term creditor. It is unlikely that a universal set of rules can resolve this contradiction.

Some flexibility was recently conceded for applying the fair value principle, to the detriment of the coherence of values applied to a same asset, with some leeway given to the owners to classify their assets in either a transaction portfolio or an investment.

There is an urgent need to go deeper into this question in particular for cross-border financial institutions and for listed ones. Should clear principles be set up to allow a consistent use of the fair value in particular to properly take into account:

- Certain financial players with either specific investment maturity needs or positions matched within their balance sheet,
- Whether assets are not liquid enough to ensure market prices are sufficiently reliable.
- The necessity to do not disclose financial groups strategic positions

In particular in that respect the conclusions of the work initiated on 23 December 2008 by IASB³ involving trade associations in the EU are urgently needed. Appropriate comments should be published to allow analyst and investors to interpret the figures published. A greater degree of certainty and of uniformity is badly needed.

Only the combination of these two approaches would make it possible to identify the very nature of provisions affecting banks' performances (market dysfunctioning, economic crisis, etc.). These measures would over time reflect the actual economic performance of these various assets, which are often representative of underlyings that are far from all being "non-performing". They would also help to assess the actual fragility of the banks and provide the political authorities with a common and reliable basis for regular updates on the stability of the financial system in their countries.

The transparency of asset backed securities, especially those whose underlyings are made up of mortgages, deserves a particular attention. It should be improved by defining and standardising the information that must be provided by the various players in securitisation operations, and by ensuring the systematic disclosure of such information.

Beyond its usual general guidance more specific action is required from the G20 to bring together the conditions for a return to confidence and facilitate the States' intervention

- Such initiatives should ideally be carried out on a global level and be initiated by the G20 at the beginning of April.
- Accounting rules and naming systems should be defined by the Financial Stability Forum, IASB and FASB, according to their respective fields of competence.
- In case such methods would be optional and not compulsory, the banks adopting them would be awarded a label by the national supervisors highlighting their high degree of transparency and enabling their identification by investors.
- It can be envisaged to limit this disclosure to national supervisors which would be in this specific context responsible for commenting upon the quality of the solvency related to financial institution under their scrutiny. This option is suggested by some Eurofi partners who want to avoid excessive quantity information or to avoid any possible increase of mistrust resulting from the extent of bad assets.
- Independent auditors should receive a specific mandate to pay a special attention to the consistency of their implementation.

If a quick consensus cannot be reached on these principles during the next G20 meeting, Europe could adopt this approach by the end of March in view of re launching banks' various refinancing instruments and facilitate the contraction of the balance sheets of the ECB and the national central banks.

Such an approach would not in any way preclude any moves by States to support the banking system, but on the contrary would provide a basis for ensuring the validity of their intervention. Indeed it is a precondition to avoid that some states mobilize excessive financial resources to this support and doing so they would create the condition for long lasting unlevel playing field among financial institutions hindering in particular either further EU financial integration or cross border restructuring.

³ Amendments to IFRS 7 Financial Instruments: Disclosures - Credit Crisis: <http://www.iasplus.com/agenda/ifrs7issues.htm#ed2>