

### Eurofi 2008 –



Thursday 11/09/08

**Session [3a] RESTORING INVESTORS' CONFIDENCE: Regulation/self-regulation to restoring market transparency, improving originators behaviours, providing appropriate**

**information on risks for professional/individual investors (Rating agencies...), increasing transparency for risk Securitisation...**

#### The Panel

Moderator: **Jacques de Larosière**, Co-President, Eurofi

Panelists: **Baron Alexandre Lamfalussy**;

**Gérard de la Martinière**, President, European Insurance and Reinsurance Association (CEA);

**Ian Bell**, Senior European Legal Counsel, Standard &

Poor's

**Eddy Wymeersch**, Chairman, Committee of the European Securities Regulators (CESR)

**René Karsenti**, Executive President, International Capital Markets Association (ICMA); **David Wright**, Deputy Director General, DG Internal Market and Services, European Commission;

#### The Debate

It was a lack of confidence about the information published by financial institutions, especially banks, that was largely responsible for the unusual shape of the yield curve in the interbank market, said **Baron Alexandre Lamfalussy**. Lost confidence sprang from repeated writedowns of sub-prime-related assets, unexpected profit and loss figures, uncertainty around the need to raise equity and poor communication by bank management. "This suggests that banks were ignorant of what was happening in their own banks, or preferred not to tell the truth about it," he said.

To some extent, they had some excuse for not being able to deliver credible forecasts in the midst of a crisis that was far more complex than any others over the last 30 years. The sub-prime crisis was both a trigger and an aggravating factor at a time when the "prevailing euphoria" allowed the mispricing of risk amid a massive wave of securitisation. "The mind-boggling complexity of financial instruments aggravated the opacity and made the search for the 'final lender' a hopeless exercise just as the

traditional credit cycle was coming to an end," Baron Lamfalussy said. On top of this, global macro imbalances implied a risk of disruptive exchange and interest rate adjustments and there was an explosion in the price and volatility of commodities that added to generalised uncertainty.

While macro policy tools should be able to speed up the return of confidence, at what price, he asked presciently, the week before Lehman Brothers collapsed and the US Treasury announced its controversial \$700bn bail-out plan. "Bailing out banks may be justified and could restore confidence, but if it does not penalise very heavily managers, shareholders and imprudent lenders, the moral hazard implications would store up trouble for the future and could be devastating."

The market lost confidence in published accounts because a consensus emerged about the desirability of extending the role of market prices in valuing assets and liabilities just as the value of market prices fell sharply because of vanishing liquidity. There was a resort to mark-to-model techniques but there was no consensus on the design of the models. "There are as many models as there are banks, probably more, which implies more than one model in some banks," he added. A number of banks "miserably failed" to manage their risks by using optimistic valuation models. "It is no wonder confidence has been eroded."

There was an urgent need to remedy this because confidence had not returned despite the response to repeated requests by the authorities to candidly disclose the value of assets held by banks. Confidence hinged on reliable valuation methods that allowed comparison between banks. What was needed was an industry-wide agreement on the models used by banks or at least precise disclosure of the model used, allowing the reader to decide if he liked the model or not. However, given the complexities involved, "any such assessment would require a remarkable dose of expertise," he added.

Baron Lamfalussy suggested an intermediate solution – would it be possible to agree on a set of core principles that all models should respect, he asked? "Great attention must also be devoted to the use and abuse of misleading probability calculations that have done so much damage to the credibility of stress-testing exercises."

Finally, he said there was a need for strong co-operation between the industry, regulators and auditors, with the industry playing a major part in the drafting of core principles. However, the implementation "cannot be left to self-regulation. It should be part of the regulatory process." There were major hurdles, including the need for any agreement to be global and the difficulty of getting a genuinely co-operative effort by banks, but – again, presciently – he said: "The consequences of doing nothing could be most painful for the banks themselves."

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The crisis of confidence was mainly affecting institutional investors, said **G rard de la Martini re**, President, European Insurance and Reinsurance Association (CEA). "For retail customers I do not see much effect. Although they are not inclined to invest, there is no need for any adjustment in regulation of retail financial products." The priority was institutional investors – it was vital that there was a healthy market for long-term savings because of the need for pensions.

"I am very concerned about the banking sector, because banks play a critical role in every aspect of the financial system." It was not just a question of recognising losses and making write-offs, he added. "To what extent can we rely on the quality of risk management at banks?" he asked. "Is financial regulation adequate for banking supervision? We were told that Basel II was ne plus ultra but there are real questions about the sustainability of banks' business models."

What would bring investors back into the market, Mr de la Martini re continued? For investors who used a lot of leverage, such as LBOs and hedge funds, there was probably a need for some clarity from central banks about how leveraged financial activity would be monitored, while growth investors were still waiting for the global economic outlook to stabilise. Value investors, who should be playing a significant role in present circumstances, were staying on the sidelines because it was impossible to make judgments about the value of shares. "If you are not convinced we have reached the bottom, it is better not to invest even if you think the price is right. Market valuations are not allowing value investors to play their role, which may delay any recovery."

The likely lessons investors would draw from the crisis would change the investment process. "We will see a low level of delegation, more direct monitoring and direct management of investments and risk rather than products such as funds of funds, which carry the risk of removing the possibility of evaluating the level of risk in the product," he added. Securitisation will be screened very carefully and will require high quality and detailed information to make investors comfortable with the type of risk they are carrying. Meanwhile, ratings will be based on observation of the existing situation rather than built-in ratings made for specific products.

The insurance industry, contrary to expectations, had not seen significant exposure to the turmoil because the industry's investment process was very disciplined, directed by asset liabilities and golden rules on not investing in assets not denominated in your own currency.

Solvency II would have a very significant effect on investment policies for insurers, but it was important for them to keep some flexibility and pragmatism in the way assets were analysed, under appropriate prudential control.

**Ian Bell**, Senior European Legal Counsel, Standard & Poor's, said that his industry was facing an important time, with EU proposals to regulate the ratings agencies an entirely reasonable attempt to re-establish confidence in the work they did and in the market as a whole. While the proposals represented "a political desire to create a regulatory scheme including the ratings agencies and we are very grateful for the opportunity to comment, the present proposal creates some serious concerns about potential unintended consequences on access to cheap capital for European institutions and lending to European consumers." As a result, Mr Bell recommended an impact study on the proposals.

It was important to reflect on what a rating was, he added. The EU proposal seemed to treat ratings as scientific facts capable of being created true or false, right or wrong. But "they are no more than an opinion about the future – they are inherently uncertain."

Who could have predicted just weeks ago that the Republican vice-presidential candidate could be Sarah Palin, the governor of a state with a smaller population than a Paris arrondissement, he asked? "There are always going to be uncertainties. If your job is to predict the future, there are times when you will get it wrong – in a perfectly legitimate way."

Nonetheless, people had a right to know ratings were decided without conflict of interest and that was a legitimate purpose of regulation. There was also a legitimate expectation that ratings would be created in a competent way and that agencies had done the appropriate due diligence. The EU proposals went beyond this, however, Mr Bell said and failed to provide for global consistency. "Ratings provide global benchmarks in global capital markets. We need to do global work consistently – if we are subject to balkanised regimes that require us to do something different in Japan, the US and Europe, we risk destroying that benchmark regime that gives investors the confidence to invest." The value of agencies was that their opinions were independent and not influenced by political agencies that had their own agenda.

While the preamble to the proposal did talk about not interfering, the detail painted a very different picture and gave regulators a direct influence on a variety of aspects of agencies' work that looked like they were procedural, rather than matters of content. However, Mr Bell said, issuers never called the ratings agencies and said they were wrong – they always couched any criticism in terms of process, saying 'you have not applied your criteria consistently'.

The proposal would allow regulators to say the same thing, he added, and that opened the door for potential interference. "Regulators may be tempted, under political pressure, to do so. And even if all 27 regulators that have that power don't ever succumb to the temptation to do so, investors will believe that they can do it and it undermines confidence."

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Currently, the ratings agencies fielded these calls, but “we are very concerned that in future regulators could be called by ministers, leading to a pressure on regulators that is unhealthy for capital markets”. It could also lead to moral hazard for the regulatory community. To take a case such as the sub-prime crisis in the US, investors could say that if regulators did not intervene, they were indirectly saying the ratings were ok.

“By allowing direct interference, the present scheme is bad for capital markets, bad for the ratings agencies, bad for regulators and bad for companies. We recognise that regulation is a political necessity, but the industry should be allowed to come up with rules and codes of conduct – to be examined and approved or otherwise by regulators – and then our compliance with those codes checked without direct regulation, which would lead to a morass of second-guessing individual ratings decisions,” Mr Bell concluded.

**Eddy Wymeersch**, Chairman, Committee of the European Securities Regulators (CESR) pointed out that ratings over the last year had led to big shocks for investors and massive withdrawals from investment funds. UBS, for example, had been losing asset management clients because those clients had lost confidence in the way UBS was being managed.

“There is a widespread lack of confidence in the system but nonetheless, we have to be prudent in this field. I am afraid of over-reaction – Sarbanes-Oxley was a classic case of over-reaction that we are still suffering from,” the CESR chief said. Ratings agencies – the gatekeepers of the system – had to be sufficiently supervised that markets could rely on them.

Changes to the fair value system would risk destabilising the system even more, “but we have to make sure that valuation by ‘the mystery of the models’ is reduced to the utmost”. The only real touchstone for value was the market, he added, so more securities should be traded on public markets, where prices were disclosed. “Some of these models look like the models in the Middle Ages for finding gold – and no gold is to be found there.”

The margins for tinkering with fair value were limited – disclosure was at the limits but confidence had still not returned because the crisis was much more fundamental. Something had to be done about disclosure, he added. “250 pages of prospectus and 15 pages of appendices – I am sorry, but this is not disclosure.”

Adequate policies were needed for risk analysis, taking into account macro as well as micro factors. “It is quite amazing that many European businesses did not follow US real estate markets even though there were clear signs that the market was having problems. The information was easily available but no-one cared.”

Governance of financial institutions had to be tight but it had emerged

from the Northern Rock debacle that the non-executive directors had been utterly ineffective. “It is quite a danger to have fully non-executive boards. You need several non-execs and several independent directors. Dominant CEOs have to be removed in time, before problems start. Each time there is a crisis, it is because of a dominant figure,” Mr Wymeersch said.

Boards had to be more responsible for risk assessment and remuneration and incentives had to be based on long-term targets. “If companies won’t do it voluntarily, then it has to be fixed by law, as it is in the Netherlands. It is unfortunate, but that is the way it is.” Risk assessment should include factors other than the traditional financial risks, he added. “Products are put on the market that are extremely dangerous to investors and a few years later, the chickens come home to roost, in some cases almost bringing down the bank.”

Products were still being sold, not because they were in the interests of investors but because they were product of the month in banks and because of the fees available.

Mr Wymeersch ended on a positive note – in the midst of the turmoil, public markets had functioned very well, with stock exchanges, payments systems and clearing and settlement all working with almost no glitches despite massively increased trading volumes.

The benefits that were expected to flow from financial innovation had instead become associated with “a new confederation of risk”, said **René Karsenti**, Executive President, International Capital Markets Association (ICMA). Investors anxious to increase their returns assumed complex risk that was not always fully understood and this was compounded by outsourcing of internal due diligence to ratings agencies.

What measures were needed to restore confidence and what had been done so far, Mr Karsenti asked?

- 1) Intervention by financial authorities had been necessary and the ECB had played a critical role in this regard by frontloading the provision of liquidity. Meanwhile, the US had stepped in to rescue Fannie Mae, Freddie Mac and Bear Stearns. (Mr Karsenti’s comments came before the US Treasury’s \$700bn bail-out plan and lifeline to AIG)
- 2) Questions remained about the ability of European authorities to handle a crisis involving a cross-border institution deemed too big to fail. “The colleges of supervisors are welcome, but it is not yet clear how they would cope with such a default.”
- 3) Restoring confidence in the ratings agencies was critical. There was concern that EU proposals could lead to interference in the ratings process, which would tend to undermine investor confidence. “Any approach to supervising ratings agencies should be tackled at a global level.”

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4) Although regulators' role in restoring confidence was critical, it was not sufficient, in itself – the investor community must help as well. "We are playing a role by ensuring maximum disclosure but we need to address the problem of how to value securities, particularly when markets are closed."

5) New regulation is important. "We want better regulation but not more regulation. Regulators should learn from elsewhere and new rules should be the last resort for restoring confidence."

Regulation without proper consultation carried the risk of unintended consequences. An example was the proposal to require originators to retain at least 10% of any securitised assets, Mr Karsenti said. "Setting strict guidelines is not necessarily the best way to achieve the objective. It will increase the cost of capital and put the industry in the EU at a competitive disadvantage globally."

Responding on behalf of the regulatory community, **David Wright**, Deputy Director General, DG Internal Market and Services, European Commission, said that – given Europe's position as the world's biggest capital market – "we have to find a proportional European policy response. It must be co-ordinated, it must be serious, it must be consistent and there must be communication to ensure we are all pulling in the same direction."

It was important to avoid scattergun, knee-jerk reactions from different member states that could do more harm than good. "We have to work with our partners, including the US and we have to get incentives and penalties right in the capital markets. Do we have sufficiently dissuasive sanctions regimes to deter the excesses we have seen in the past?" he asked. Mr Wright also highlighted the need for strong ethical leadership from the industry. "It is an industry that has made some colossally bad investments. It would not be so bad if it was just the industry losing money but it has damaged the lives of ordinary people. We need people to stand up and make a difference."

The Commission's approach was based on four strands, he said. The first was **transparency** and improving the quality of the data. "We still do not know how big the issuance of securitised assets is and the exposure of European institutions. We have a feeling that there is well over \$1 trillion in securitised assets and that European groups are holding 50% of it but we still don't know. That is quite astounding one year on from the start of the turmoil."

There was a need for consistent bank reporting to bring confidence back to the market. Many markets had functioned well, such as equities, bonds, foreign exchange and clearing and settlement. The common characteristic of all these markets was transparency. "If we cannot have consumers who understand what they are buying – and the majority don't – then we have an asymmetric system that is not sustainable in the long term."

The second strand was **valuation and accounting issues**. Consistent application of accounting standards was vital and work was needed on how to measure illiquid markets. "How big is this problem? Some major players say that even the most complex products can be valued very accurately, others say 50% of the loan book cannot be. If the market does not know what the price is, we will not restore confidence."

Another problem was pro-cyclicality, which arose out of the interface between bank oversight and accountancy regulation. Mr Wright suggested there was a role for dynamic provisioning as well. "Surely it makes sense for banks to be able to put reserves by in the good times? How can that be handled in an accounting way and conveyed to the market in a way that everyone understands?" he asked. It was important to have strengthened governance from the IASB but there should also be input from banking regulators to avoid any unintended consequences.

On **strengthening capital requirements**, the Commission thought there was a need for progress on large exposures, improving the quality of hybrid capital and strengthening group supervision. "We also need to bring in the principle of risk management from Basel II and deal with the right incentives for the originate and distribute model."

"Is the answer to strengthen transparency on the issuer side, to impose quite draconian due diligence requirements on investors or to require originators to maintain a 'skin in the game'?" he asked.

Commissioner McCreevy had brought forward proposals to deal with three major failings with regard to **ratings agencies**. These were conflict of interest, transparency and quality of ratings. Mr Wright acknowledged that there were some issues that needed reflection. "It is not the intention of the Commission to interfere with the independent judgment of the ratings agencies but it is its intent to ensure that that judgment takes place in a climate of full transparency." While there were legal constraints on what could be done because of the existence of the Level 3 committees, strengthening the governance would remove conflicts of interest. Ultimately, the Commission aimed to deliver a directive encouraging competition and new entrants into the market.

Finally, Mr Wright said: "We have to think hard about regulatory competencies and resources. We need to ask about the cost benefits of having more regulators and paying them a bit better to ensure quality. If you do not have regulators that understand every aspect of financial markets, how can we regulate in a good way? At European, national or any other level, we have to look at ensuring that resources are sufficient and it is my view that they are not."

A questioner from the audience said that **Jacques de Larosière**, moderating the debate, seemed to have some reservations about Mr Bell's comments and asked if he would care to expand.

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The financial system had relied much too heavily on ratings agencies in the years before the sub-prime crisis, Mr de Larosière said. "I am not convinced – and that is an understatement – that those banks that originated and securitised sub-prime credits had done sufficient due diligence on the quality of the assets."

With the financial industry having slid into a very market-driven focus, the temptation for originators was to rely, probably excessively, on ratings agencies to qualify the ratings of these products. At the same time, regulators had not sufficiently concentrated on the new financial model that was developing, where banks were relying very heavily on certain products. Because of this lack of attention to the transparency, or otherwise, of the industry, ratings agencies became de facto supervisors of very large quantities of assets that had not previously been traded in the same way.

The agencies were not equipped to do this because of the very rapid transformation of the market over the last five years. "If you look at the way they rated some of these products, they did not pay sufficient attention

to the enormous burst in the price of housing in the US, which would obviously stop at some time." Given the certainty that the market would turn at some time, "I think some of the AAAs we saw would certainly not have happened". "Did institutional investors do their due diligence on the quality of the sub-prime levels of these complex problems? The answer is no."

The banking system took advantage of the fantastic dispersion of risk. "There was an immense desire from institutions to get their hands on assets that yielded a bit more than the rather low yields on offer. The whole thing was in the hands of the ratings agencies, which did a very poor job. I am not criticising the agencies," Mr de Larosière said, to laughter, "I am criticising the creation of a system that relied excessively on agencies that did not have the methodologies to deal with that type of product."

He agreed with Mr Bell that nothing should be done to interfere with the agencies freedom of assessment but everyone had to be aware of the need for caution over due diligence.

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