



**Eurofi 2008 -
Thursday 11/09/08
Session [4A] PRUDENTIAL
AND ACCOUNTING
REGULATORY IMPACTS:
Liquidity requirements;
Assessing assets and
liabilities in illiquid markets;
Prudential-regulation
global adoption; ...**

The Panel

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

Panelists: **Kerstin af Jochnick**, Chair, Committee of European Banking Supervisors (CEBS);

Christian Noyer, governor, Banque de France;

Edmond Alphandéry, Chairman of the Supervisory Board, Caisse Nationale de Prévoyance (CNP);

Philippe Danjou, Board member, IASB

Rene Ricol, President, Ricol, Lasteyrie & Associés

Pierre Delsaux, Director, Free Movement of Capital, Company Law and Corporate Governance, DG Internal Market and Services, European Commission;

The Debate

While much had been achieved in the last four years in terms of converging supervisory practices, much remained to do and convergence remained high on the agenda of the Level 3 committees, said **Kerstin af Jochnick**, Chair of the Committee of European Banking Supervisors (CEBS).

Since August 2007, co-operation had taken on new forms, she said, and there were new issues to deal with, such as addressing bank liquidity and liquidity risk management. CEBS was concerned about the disclosure of exposures to structured products and illiquid instruments. The committee had published a paper on liquidity risk management, Ms af Jochnick said, with proposals to improve internal governance mechanism and stress testing. Following up David Wright's call in the previous session, she added: "Supervisors must have more resources to deal with liquidity risk provisions and challenge firms' assumptions on their stress-testing. We need a robust process."

"How can we improve transparency on exposure to structured and illiquid products?" she asked. "It is very easy to lose confidence, but not so easy to restore it. It will not take just one quarter." Work was needed to bring about better transparency on bank exposure to structured finance vehicles

so the market and other stakeholders understood what was going on. CEBS had analysed 22 banks and found that there was divergence in the levels of disclosure. "It is not easy to compare banks and understand where they stand in relation to their peers, while information on valuation of exposures is rather generic, which leads to market uncertainty."

A CEBS report on good practice in transparency, published in June, had led to improvements in quantitative information, but problems remained in the valuation of illiquid assets because as market liquidity disappeared, formerly observable market data disappeared along with it. This led some institutions to turn to model valuations for some of their exposures while others searched for ways to use market values. "This led to a lack of consistency, even within banks, to uncertainty about the accuracy of valuations and inadequate transparency on how banks valued exposures. There is room for improvement here and an urgent need for some guidance for banks and the authorities."

CEBS was involved in a dialogue with the IASB and the IAAB, the accounting and auditing standards setters, on valuation issues. CEBS had also during 2008 provided the Commission with advice on the definition of hybrid instruments to be included in Tier 1 Capital, since it was important for banks to have high quality assets in their capital base. The committee had also suggested a sharp focus on large exposures and the establishment of a limits-based backstop regime.

"Supervisors are doing a great deal in response to the crisis," Ms af Jochnick concluded, "but the causes of the crisis are in the hands of bank boards and management, so it is important that they improve their risk management mechanisms and risk control systems."

Christian Noyer, governor, Banque de France, said that while it was clear uncertainty persisted and markets were by no means back to normal conditions, "I hope it is a general feeling that the central banks have been able to contain the effects of market turbulence".

Even though questions abounded about some financial intermediaries, there were causes for relative optimism, at least from the French perspective. "Our banks remain robust and well equipped to withstand shocks. The supervisory regimes have helped us to manage the crisis, even if future improvements are needed at European level," he said.

The global banking sector was going through a process of adjustment, with asset values being marked down, capital balances affected and there had been a process of deleveraging after excessive expansion of balance sheets. "Absorbing the aftermath of the sub-prime crisis has been quite a challenge and further shocks cannot be excluded. Stock market conditions make it more difficult for banks to raise additional capital," Mr Noyer pointed out.

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Yet, on the whole the French banking system seemed to have weathered shocks rather well. Almost all banks had posted profits in recent quarters, even if they were sharply down on the previous year, and average Tier 1 capital ratios remained at high levels. And this was not because banks from the euro area had not been as aggressive in writing down assets as in other parts of the world. "There is no evidence to support this perception," he said. Analysts made judgments by comparing ratios and total writedowns in different institutions, but "everyone is in a different situation – their exposure to sub-prime differs in size and form"

Business models also differed, with French banks able to use revenue from recurrent sources of income to offset the significant markdowns they had to make. Retail banking had also done well and new loans were rising by about 2%, "and all this provides some comfort looking ahead, even if future shocks could severely test the resilience of banks and financial institutions".

The crisis had given new impetus to discussions on supervision, the central bank governor said and there were two lessons he would draw from the events of the last year.

Firstly, "there are clear advantages to having banking supervision close to the central bank. It is the conclusion shared by all central bankers in the world." It was not chance that the Eurosystem was praised for managing liquidity, it was by and large because a number of important members of the Eurosystem were also in charge of banking supervision. "Intimate knowledge of the sector and the different institutions is extremely helpful in reducing stress and tension in the money and credit markets."

Central banks had had to make almost instant decisions on provision of liquidity in different forms and different maturities. The distinction between liquidity and solvency problems had become much more difficult to make and "having all the cards in your hands minimises the risk of making mistakes".

Secondly, when it came to supervisory infrastructure, simple arrangements had performed better than more sophisticated systems. "There is a need for deep reflection on the optimal structure of financial supervision in Europe," Mr Noyer said. "Market integration is moving so quickly that supervisors have to adapt. I am a strong supporter of the Lamfalussy process and believe that efforts to improve it deserve our attention."

Those bits of the system that worked well should be left unchanged and any changes should be based on reality rather than theoretical ideas. "I would caution against the temptation of the MoU (memorandum of understanding) in support of international supervisory co-operation, which are very fashionable now for crisis management. They are necessary, but they must be submitted to cost-benefit tests to ensure they do not give us a false sense of security and make taking action more complicated than

it should be," he added.

Looking forward, there were two priorities – the need to develop a macro-prudential approach that would better account for systemic risks and work as a complement to the micro-prudential approach; and work to reduce pro-cyclicality in the financial system, which was related to the need for a close relationship between supervisors and central bankers. "We need to fulfill the ambitions of the Lamfalussy process and encourage convergence of rules and practice across Europe."

Level 2 committees should focus on the rule-making process and "we must eliminate national options if we want a consistent system in Europe that fosters real regulatory convergence". The Level 3 committees should firmly engage on harmonisation of practice – identical reporting and uniform application of accounting rules was crucial. "The efficiency of supervision of cross-border groups should be enhanced through colleges of supervisors. This is a huge task, but we must do it as soon as possible if we want the colleges of supervisors to work properly," Mr Noyer concluded.

Edmond Alphandéry, Chairman of the Supervisory Board, Caisse Nationale de Prévoyance (CNP), said that Eurofi had produced a set of proposals for mitigating systemic risk from cross-border banking groups, which were an excellent blueprint. He picked out three main themes from the proposals.

- 1) Harmonisation of prudential legislation in member states
- 2) Group supervisors should be responsible for solvency and liquidity transfers within cross-border groups
- 3) A regulatory review of the proposed framework on lead and host supervisors by the Lamfalussy committees.

"All these proposals should be adopted – we have to react swiftly and efficiently," Mr Alphandéry said. If there were to be a Northern Rock-style crisis, but involving a group with significant cross-border activities, there were three risks, he added.

- 1) A lack of cohesion between many bodies
- 2) No burden-sharing scheme in the event of a publically-funded bailout
- 3) The absence of a European deposit guarantee scheme.

The underlying principles of the current framework dated from the Maastricht Treaty, when central banking and supervisory functions were separated. In the Eurosystem, monetary policy responsibilities were transferred to international level while responsibility for financial stability remained with national governments.

"We must pay much more attention to liquidity risk management," he added. It was a risk not just to individual institutions but to the system

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as a whole.

“For cross-border groups, who is in a better position to monitor, assess and manage liquidity risks than the ECB?” he added. “The ECB’s job is to face global liquidity issues in the market. Why not strengthen the role by enlarging its mandate to supervising cross-border institutions?” After all, the ECB wanted the Lamfalussy process to work more effectively, stressing the need for closer co-operation between supervisors and central banks. It appeared that the ECB was afraid of a conflict of interest between its price stability role and any financial stability responsibilities but the trend was in favour of reinforcing the supervisory powers of central banks.

What was happening in the US, where the Federal Reserve was asking banks to test their balance sheets in case of major liquidity shortages, was seen as a harbinger of an extension of the Fed’s regulatory powers. “When the entire system is at stake, we should have a centralised operation organised at EU level. The ECB, as the lender of last resort, should be responsible for overseeing supervisory needs. I do not see any institution better suited for this role.”

There was always the risk of “not putting out the fire in time” in any crisis situation, and with cross-border groups, that would be harmful to every member state, meaning that the idea of public funding shared by the countries concerned gained legitimacy. Critics argued that such an ex-ante burden-sharing scheme created moral hazard, but “is this moral hazard argument not oversold in this case,” Mr Alphandéry argued. “With all these cross-border groups seen as too big to fail, is the disadvantage of knowing in advance the financial terms of a rescue not outweighed by the gains in speed and efficiency?”

The IFRS accounting framework had become the global standard on company reporting, said Philippe Danjou, board member, IASB, with even the US looking at whether to move towards IFRS within the next few years. There were great advantages in having a single global set of accounting standards, but they had to be applied consistently.

The EU endorsement procedure was accepted as necessary to give the standards, proposed by a private body, the force of law. But, given the technical nature of the standards, it was asking a lot for the European Parliament to approve something they could not be involved in drawing up and it was important for the IASB to do its part to facilitate the EU approval process. “We have increased co-operation with EU institutions and established formal links to public authorities to ensure they are fully informed about the projects we are working on.”

In the financial industry, poor lending and investment policies had been made worse by a lack of understanding by the investment and finance community of where the losses were located. “Confidence will only return once all losses are fully disclosed. The investors need more disclosure, not less.”

The board was working with the Financial Stability Forum on improving financial reporting in key areas, starting with fair value measurements, particularly in illiquid markets. “I noted Mr Wymeersch’s comments in the last session that when dealing with a trading book, fair value was the only solution, but that it is sometimes difficult to apply that principle in current circumstances.” More guidance was needed on how to use fair value measurements and when to fall back on the use of models, as well as on the necessary disclosures. The IASB was mindful of its responsibility to provide more guidance on the application of the fair value accounting, particularly on when prices transacted on in an illiquid market were not a fair reflection of value. IASB was about to issue the report of an experts advisory panel containing educational and guidance material on this subject.

There had also been excessive use of non-consolidated special purpose vehicles (SPVs) and the IASB was drafting new standards on consolidation and securitization. “The question is: under what circumstances can you say ‘this asset is no longer my asset – I have no risk’,” Mr Danjou said. It could however be dangerous for economic growth to go back to a situation where there was no securitization at all, he added, and an appropriate balance had to be found.

There was a misperception that fair value had to be applied across the board in the accounts of financial institutions. There was a clear differentiation and in average about 50% of the balance sheet was held at cost and 50% at fair value. Banking book loans and receivables were held at cost, for example, “unless the bank has chosen to apply the fair value option”. Nonetheless, this “mixed attributes” accounting standard was very complex, which meant only a few people really understood the standard. There had been requests to make it simpler, but “more simplicity means fewer classes and fewer options for measuring the value of financial instruments, which could lead to proposals to go towards more fair value”.

There were however some concerns that this would not meaningfully depict the business model of certain retail banks and thus provide information that would not be useful to investors, which is the objective of financial information. Mr Danjou noted it was likely that to some degree, a mixed attributes accounting model would continue. Also, reacting to the call made by some to suspend fair value accounting, “would changing standards in the middle of a crisis really help confidence?” Mr Danjou asked. “Changing standards requires due process and is not a solution in the short term. CESR’s proposals to improve the way the current standards are applied, to make sure there is more disclosure and transparency, are more fruitful than rushing into changes.

There could be some level of pro-cyclicality when accounting standards were combined with prudential requirements without appropriate filters,

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“but I would be cautious about addressing this through the accounting standards. Fair value did not cause the crisis – indeed it helped to timely reveal the consequences of faults in the system. Financial reporting has to be neutral – it describes things as they are, not as they should be. In that regard, fair value is the worst system, apart from all the others.”

Prudential standards, on the other hand, did not need to be neutral and there should be a debate on where the “circuit breakers” should be introduced. “I am not sure that tweaking the accounting system is the solution,” he concluded.

Rene Ricol, President, Ricol, Lasteyrie & Associés, and author of a report on the financial crisis for the French EU presidency, said that one of the surprising aspects of the situation was how much everyone was in agreement. “There is a consensus worldwide on a lot of aspects.”

We could continue to talk about the valuation of financial products, but “at the end of the day, we should move from a mark-to-market approach to a mark-to-model approach”. In addition, “we all agree that we need to improve risk management for banks” and there had been a lot of talk about compensation mechanisms for the industry. “These are all areas where there is a clear consensus, so we should act,” he stated.

Another aspect of the crisis was that it was clearly announced a couple of years in advance. “All players have to accept the role of supervisors and accept their authority, not say that it is time for them to retire when they start talking about irrational exuberance. Supervisors, central banks, the European Commission – they are not your best friends, they are there to make decisions and you need to recognise their authority.”

It would be wonderful to be able to pin responsibility for the crisis on one person – a lot of mistakes were made by ratings agencies, for example. But ratings agencies were not entirely responsible – it was an issue for the whole industry. While the internal processes of the agencies needed to change, there was also a need to improve risk management systems, internal control systems and the competency of boards.

It was also unfair to blame the standards, said Mr Ricol. “In markets where there is no confidence, it is because of the products, not the standards.”

The debate on the crisis was global, so if Europe wanted to play a strong role, it had to fulfil the ambition of the Lamfalussy process. “This has not been done, but what is the reason for us not to deliver what we said we would deliver? Why accept 27 different sets of rules? Do we want Europe or not? We need to be clear. I don’t think there is a lot of political debate about that.

“A lot of people are in difficult situations. We need to deliver and that will make them confident.”

There were calls for more regulation, but this was not necessarily a good thing. “That does not mean we should not have another look, though,” Mr Ricol said. The Bank of England used to have a department called Supervision and Surveillance, he went on. “Supervision means regulation, establishing rules and controls. Surveillance means being aware of what is happening and asking people to be more transparent so we can identify the key risks and adopt punctual regulation.”

If the industry wanted people to be confident in the system, why should it not be more transparent?” he asked. “There is transparency when you buy a car, a house or shares. Why not for financial services? There is no reason. If we want to avoid more regulation, we need to be more transparent.”

Finally, underpinning everything, was the issue of ethics, Mr Ricol said. “We can put in place all the rules we want, but if they are not backed by ethics, we will not avoid the next crisis.”

Pierre Delsaux, Director, Free Movement of Capital, Company Law and Corporate Governance, DG Internal Market and Services, European Commission, took an unusual approach to prudential and regulatory issues, summing up the crisis using a number of key words – fever; butterfly; trust; tango and the search for the Holy Grail.

Fever – the IFRS standards were there as an indicator – a sort of thermometer measuring the health of the financial system. If you broke the thermometer, it did not stop you having a fever. “We should keep the thermometer and apply it to everyone. In a crisis, changing the thermometer is not a good idea.”

Butterfly – this was the idea that a butterfly flapping its wings in one part of the world can cause hurricanes elsewhere. Financial markets were closely integrated and that process would not stop. “The solution is not less convergence but more, both between individual European countries and between Europe and the outside world.” An example of this was the bold move the EU made by adopting IFRS, which had been a success that others had emulated. “IFRS is important because it is a global language that helps financial markets to understand each other and investors to compare companies.

Trust – this was fundamental to rebuilding trust for investors and market players. One aspect of this was criticism in Europe about IASB. While the situation had improved, proper governance of the standard setters was important, Mr Delsaux said. One way to do this was to reinforce the relationship between public authorities and standard setters. “It does not mean standard setters will lose their independence, but independence does not you have to report to no-one, especially when standards are becoming mandatory in most parts of the world.”

Accountability and monitoring of standard setters was essential, he said,

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and consultation mechanisms needed to improve. Because standards had costs as well as benefits, there should be an impact assessment on the economic consequences of standards. "It is easy to blame the IASB for everything, but we should blame ourselves as well. We should have a strong voice in the standard-setting process, so we need adequate resources to ensure we are heard," Mr Delsaux added.

Tango – it takes two to tango. IFRS regulations should not be seen in isolation. Supervisors should be talking to central banks and to each other, as well as to the IASB and securities regulators. "We need to improve co-operation and dialogue."

Mr Delsaux joined the chorus suggesting that, while IFRS did not cause the crisis, perhaps the link between prudential requirements and IFRS could have had some consequences for the markets. "We need to talk and develop common solutions. Otherwise they will fail and this is too important for us to fail."

Hunting for the Holy Grail – everyone was looking for solutions to the crisis. These included more guidance on standards, more transparency on the models being used by banks, while there was scope for some flexibility

on fair value and the introduction of dynamic provisioning under certain conditions.

But, said Mr Delsaux: "I have some bad news for you. Indiana Jones does not exist. There is probably not a Holy Grail – one single solution that will solve everything. But that does not mean we should not look for the best solutions available. They will not be perfect but they might be enough to help solve some of the problems we face today."

Co-operation between all players had to be reinforced and solutions should be based on the facts rather than on ideology. "It is all very well to react after the crisis, but in future we should try to anticipate situations and have more in-depth pro-active regulation before the crisis starts," he said.

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