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**Session [6] - LEARNING
FROM THE FINANCIAL
CRISIS: KEY DRIVERS
AND EU INSTITUTIONS
INITIATIVES for reducing
procyclical effects; For**

an effective surveillance of off-balance sheet risks; For an appropriate setting of the banks' amount of prudential own funds; For providing reliable information to investors (rating agencies, market information...)

The Panel

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

Panellists: **Joaquín Almunia**, EU Commissioner for Economic and Monetary Affairs

Fernando Teixeira dos Santos, Portuguese Minister of State and for Finance

Dominique Hoenn, Senior Adviser, BNP Paribas

Daniel Daianu, MEP, Committee on Budgets, European Parliament

Deven Sharma, President, Standard & Poor's

Nout Wellink, Governor, De Nederlandsche Bank and Chairman of the Basel Committee

Tommaso Padoa-Schioppa, Former Italian Minister of the Economy and Finance

The Debate

Joaquín Almunia, EU Commissioner for Economic and Monetary Affairs said the main question was how to restore stability in our economies after more than one year of turmoil. "This turmoil has posed serious challenges to the financial industry and our economies. The experience has been instructive, but after more than one year of turbulence, we now have to turn lessons into action."

The European Union had not been passive. It acted quickly last autumn, adopting a road map of policy actions covering transparency, valuations, supervision and market function, including the regulatory system.

"Although our understanding has deepened this year the road map we discussed [last year] remains valid," said Mr Almunia. "The European Central bank and others have played a crucial role in containing the impact of the financial turmoil within a liquidity management framework that has proved itself flexible and robust. Several central banks, including

the Federal Reserve, have taken important actions that have helped us through some uncharted territory. Had they not stepped in to provide liquidity, the consequences for the real economy would have been much more severe."

However, he said public liquidity was only an imperfect substitute for private liquidity. "Confidence in the function of markets must recover. This is the purpose of the Ecofin programme: to tackle the weaknesses in the sector with policy action, and to boost investor confidence." Work on implementing the road map was broadly on track.

There was a need to speed up implementation, in order to meet the deadline for delivery and restore confidence as quickly as possible. "To overcome uncertainty, we must improve market transparency, providing reliable information on the size and location of credit risk within the financial system, and the characteristics of products not only in terms of credit risks. To meet these ends, we are relying heavily on the co-operation of the industry, which has committed to various measures."

The European Commission had been co-operating with international institutions to harmonise global solutions. Mr Almunia supported the call of G7 finance ministers to have the European Association of Securities Dealers initiate urgent actions in order to develop guidelines on third-party risk measurement and disclosure of balance sheet commitments. Concrete deliverables could be expected in 2009.

"We are also considering regulation on the improved transparency of credit rating agencies," he said. "We are proposing reforms to the corporate governance of these agencies, as well as measures to increase competition." He hoped these proposals would be discussed and adopted before June 2009.

Mr Almunia recognised that some of the weaknesses highlighted by the turmoil could not be solved in the short-term, such as pro-cyclicality. "Pro-cyclicality is inherent to a modern financial system. However, through the regulatory and supervisory framework we should mitigate pro-cyclical behaviour in order to ensure stability."

This would be complex and would have to be balanced against potential losses of efficiency for financial markets. "For example, as we move into the Basel II framework, some have expressed concerns that the new framework may encourage pro-cyclical behaviour."

Financial markets were one of the most dynamic elements of the global economy and ensuring their smooth running required close co-operation, both at the European and global level.

Fernando Teixeira dos Santos, Portuguese Minister of State and for Finance, recalled having to assess the state of the financial markets a year ago, when the crisis was still at an early stage.

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Given the limitations of information available at the time, Mr Teixeira dos Santos said last year's Ecofin conference had made a very accurate diagnosis of the situation. The resulting road map was still relevant and did not need major revisions or corrections in face of subsequent market developments.

The road map attempted to answer four major challenges.

- 1) The need to improve the transparency of markets. Most of the uncertainties of the past months were due to a lack of transparency in our markets.
- 2) The need to improve the valuation procedures of financial assets, and the assessment of risk management procedures.
- 3) The supervision and regulation of markets. How could we extend our framework and supervision of markets?
- 4) The result of all these efforts: how to make the market work better.

Transparency should be the result of a joint effort of market players and the authorities to prevent situations like the sub-prime crisis, and the best way to prepare an adequate response to similar crises.

The Commission's revision of the Capital Requirements Directive would be crucial for strengthening financial supervision in a regulatory framework. "The work on the credit ratings agencies was important. In this area, the requirements on the governance of this activity should be clearly set up so that we can avoid the failure in the past regarding the role of the credit rating agencies. We trusted them too much and, in some ways, the feeling we have is that they let us down."

He added: "The need to move forward with the model of College supervisors is crucial. But first we need a clear decision-making process in which we should acknowledge the importance and the higher responsibility of the home supervisor, but not neglect the role and need for co-operation and participation of the others.

"We talk a lot about co-operation but my perception is that we co-operate always as a last resort. This should become a normal thing. It is important for our regulatory and supervisory culture to introduce the European dimension in our minds, and in our framework."

There would be no co-operation if there were no information sharing, both within Europe and with other markets.

Dominique Hoenn, Senior Adviser, BNP Paribas, said the crisis of the last year had a classical cause – an exaggerated distribution of credit had led to a bull market. Regulators had acted to protect depositors by insisting on capital strengthening, but that had led to the originate to distribute model, whereby financing was taken off balance sheet in an attempt to find high returns in a low interest rate environment. This led to the distribution of ever-more risky products, notably in the US housing market.

"It was a classic bull market – it might be astonishing that it affected the whole world, but this just shows how global the asset management industry now is," he said. The immediate consequence of the crisis was that asset managers and their clients fled from anything to do with property but also any sort of leverage, leading to massive liquidity problems.

Reintermediation stabilised the margins of the banking system but had left no room for new financing, so the financial crisis was going to become an economic crisis if nothing was done.

In the short term, the only practical measure was to suppress minimum holdings, limiting the savings banks could make from moving from Basel I to Basel II. "I'm aware it is controversial to propose a reduction in reserves, but that is what is needed. We must also look again at a prudential system that reduces pro-cyclicality," he said.

Securitisation was an indispensable element of the economy, Mr Hoenn added and the temptation was to abandon the products that led to the disaster. "Let's not give in to this temptation – the complex products that were at the heart of the crisis are dead but there should be simpler, safer securitisation products that asset managers can buy with confidence if they are offered a reasonable secondary market".

The idea that the originator of a product should have to retain a portion of the risk was often floated, but it was a bad idea. All cigarette packets carry the warning "Smoking kills" – but no-one insists that tobacconists have a minimum consumption. The appetite for risk differs among market players and you simply need to ensure that those taking the risk are aware of it. "Perhaps we could ask the originator if it retained a part of the risk. But far more important is the existence of a line of liquidity."

For this proposal to see the light of day, there were two conditions. First, the reserves linked to this liquidity must be proportionate to the risk of the product and second, central banks must stand ready to provide refinancing in the event of a massive market correction, but only for simple, standardised securitisations.

In June 2007, Mr Hoenn said, a five-year euro issue for a AA bank offered a spread of 15bp over 3-month Euribor. By the end of the year, that had gone up to 80bp and as he spoke it was 115bp. More worryingly, covered bonds require a spread of 40-50bp. This increase in the cost of credit risked economic asphyxiation – if we wanted to avoid this, we had to re-establish a climate of confidence in the banking system.

"This crisis is due to a collective failure in which all actors (regulators, rating agencies, banks, asset managers) played a part. But these same actors have the responsibility of rebuilding a solid financial system," he said. This rebuilding relied on rebuilding trust between regulators and the industry, "who must hope for a good balance between *laissez-faire* and over-regulation".

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This redefinition of the rules of the game could not be restricted to the national level because all the big players were global groups. "That's why we need European supervision for cross-border groups, with a college of supervisors led by the supervisor of the country of origin, and to give CEBS the role of assuring standardised supervision of different groups."

Daniel Daianu, MEP, Committee on Budgets, European Parliament said the significance of the current financial crisis was huge, and its policy implications manifold.

"I heard one leading central banker, not long ago, saying that the depth and magnitude of this crisis could hardly have been predicted a year ago. His is not an isolated voice. But such remarks are baffling for it is the job of a central banker to focus on the health of the financial system, and not just the stability of prices.

"There have been various episodes of crises over the past two decades and there are people who learned from them. Some financiers and economists – such as Warren Buffett, Edward Gramlich, Paul Krugman, Alexander Lamfalussy, Nouriel Roubini, Paul Volcker and others – warned, years ago, that another crisis was in the making, underlining the menace posed to financial stability by new types of financial innovation."

Studies from the Bank of International Settlements and the Bank of England had examined the roots of the current crisis before it erupted. Reports of the European Parliament (one in 2002, in particular) had pointed the finger at issues that were now being widely debated. This, said Mr Daianu, posed the question: "How is it that policy-makers overlooked strong warnings, analyses and the lessons of previous crises?" He suggested that vested interests had played a role.

"Some use the complexity of financial markets as a leitmotiv when explaining this crisis. But this is pretty much a self-serving argument, hard to accept without qualification. Not all financial innovation is sound. Not all products and services in an economy are, in the end, accepted by markets. And regulations and supervisors are needed to protect consumers and investors."

Some financial products were better than others; some were flawed by design, among them those that underpinned the international quasi-Ponzi scheme that enabled firms to report abnormally high profits that did not reflect revenues generated by their businesses. He cited derivative products such as collateralised debt obligations and credit default swaps, which had made markets opaque and were, in his opinion, of more than questionable value. "It therefore makes sense to judge the nature of various financial products, and to regulate the financial industry as a whole," said Mr Daianu.

The Lamfalussy process needed much improvement if it were to cope with mounting challenges. "Some argue that since the crisis started in the

regulated sector of the financial system, its non-regulated area should be left alone," said Mr Daianu. "But this argument is ridiculous: banks have made use of loopholes and poor regulations to develop the non-regulated sector, creating a shadow banking sector."

Hedge funds contributed to increasing systemic risks. "The claim that investors are putting their own money at risk does not tell the whole story. Very high leveraging and focus on short-term gains increase overshooting. But what is even worse, the speculative nature of such operations can damage financial stability. It makes sense to bring the activity of hedge funds (and private equity funds) within the territory of regulated financial entities. Leveraging should not be unconstrained. Likewise, hedge funds should provide the regulatory and supervisory authorities with full information on their transactions."

Mr Daianu said the current crisis was a stern indictment of the incentive structures in the financial industry, in investment banking in particular, which had stimulated reckless risk-taking at the expense of necessary prudence. Some banking had turned into a "casino"-type activity, through the creation and selling of new types of securities. This asymmetric compensation scheme had to be corrected and the culture of investment banking had to change for the benefit of the economy as a whole.

But inappropriate compensation schemes operated in other industries, too, he warned. "There are numerous CEOs who receive incredibly high salaries and bonuses despite the shaky performance of their companies. There is a huge ethical issue here, one that needs to be addressed by politicians and policy-makers: How can we ask citizens to bear the brunt of painful adjustments when some of those who have been deeply involved in creating this mess are shunning responsibility, or are not accountable?"

Mr Daianu said one of the questions posed by the crisis was about policy. As a rule, the pro-cyclical use of monetary and budget policies should be avoided. "One can argue that price stability should play second fiddle when financial stability is at stake, but one has to keep in mind the effects of injecting liquidity into the system when inflation is on the rise. This crisis reminds us again about the risks of financial liberalisation when institutions are not congruent or when markets are not functioning smoothly."

Some claimed that cheap money was at the origin of the crisis. But that was, he said, a very incomplete explanation. "A lax monetary policy cannot, on its own, cause a meltdown of the financial system. This is the crux of the matter: structural features of the "new" financial system, including a breakdown of due diligence, have brought upon it the threat of total collapse."

The structuring of fiscal policies also had to change. It was, for example, quite odd to see Americans saving so little and their deficits being financed

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by emerging economies. "Moving further along this line of reasoning, one reaches the issue of policy co-ordination against the backdrop of financial globalisation: Is co-ordination appropriate?" he asked. "Do we have proper structures of global governance? Unless we manage globalisation adequately, rising nationalism and populism in policy-making could reverse the evolution toward more open markets. The quest for energy security and affordable food could easily make things worse."

Arguably, the view that the market should be seen as the solution for all decision-making, a view that had much influenced policy-making in the last couple of decades, had been fatally wounded by this crisis. "Modern economies do need regulations in order to be as civil as possible to their citizens."

The correction, he said, would be painful, especially in the US, but Europe was not immune to economic downturn. Solutions should not be patchy and should take into account the fact that markets are global. International coordination was needed in order to restore confidence.

Deven Sharma, President, Standard & Poor's, noted that the credit correction was still playing out at the time of the conference, with actions by central banks, treasuries and policymakers around the world.

A number of international bodies such as the Financial Stability Forum, the Institute of International Finance, and the Bank for International Settlements had done a lot of good work in addressing the issues from a global perspective, and a number of common solutions were emerging.

"First and foremost, there needs to be more transparency at all stages of the capital raising and investment process," he said. "Ratings firms have an important part to play in improving relevant information in capital markets – and at Standard & Poor's we are taking a series of actions to increase transparency both of our ratings analytics and the way we operate."

Second, he said structured securities, which had been at the centre of the turmoil, needed to be addressed on several fronts. "Investors need additional tools – beyond ratings and the prospectus attached to a new security – for analysing the bonds they buy.

"It is important to note that our ratings are opinions about default risk, and default risk only. They don't address suitability, volatility, valuation or the many other factors that investors need to look at before buying a security – and they are just one of many factors that influence the market pricing and performance of bonds."

Standard & Poor's was working with the market to develop additional analysis and benchmarks of non-default risks such as correlation, recovery and volatility. "We are changing our methodology to factor ratings stability, not just ultimate default risk, into our ratings. Investors should look at this broader set of factors, as well as at the amount of leverage in their portfolios and the securities they hold, in making their investment decisions."

Third, he said there needed to be clearer accountability at each stage of the capital raising and investment process - origination, structuring, rating, selling, buying and valuation of securities, and for data quality, analytical standards and product suitability.

Standard & Poor's was intent on equipping investors with the analytics and tools they needed to make more informed investment decisions. "We are taking additional steps to evaluate the quality of the data we rely on. We are expanding our analytics, increasing the disclosure of collateral supporting structured securities, providing more visibility of our assumptions and stress scenarios, and initiating an investor education program. And we are continuing to issue regular reports to update the market on our progress in implementing these measures, to demonstrate our commitment."

He said ratings could only be part of the solution to restore confidence in the debt markets. The challenge was to rebuild confidence in debt markets as a whole, including the pricing and valuation of complex debt securities, as well as confidence in the financial health of institutions that hold or trade illiquid instruments.

On the oversight of ratings agencies, Mr Sharma said "We recognise the desire for additional external supervision of rating agencies in Europe and internationally. In fact, I believe that an enhanced oversight regime – if carefully crafted - could help in the process of restoring market confidence."

For such a regime to be effective, however, it would need to follow three key principles.

- 1) It should be internationally consistent, recognising the global nature of debt markets and ratings agencies
- 2) It should explicitly preserve the independence of ratings opinions and methodologies
- 3) It would need a single point of entry for registration, oversight and co-ordination

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"A regime based on these principles could, I believe, meet the European Commission's aims of supporting the objectivity, quality and transparency of ratings opinions," he said. "At the same time, it could meet the needs of the broader market by creating a framework that investors will view as underpinning the international consistency and comparability of credit ratings."

There was considerable concern that the Commission's proposals would not achieve their very laudable aims. The proposals envisaged a stand-alone set of detailed requirements for ratings agencies and provided scope for intervention in ratings by any regulator in the European Union. "That has raised worries in the market about the risk of unintended consequences for investors and issuers – and that supervisors may be placed in a position where they have to second guess the content of individual ratings," said Mr Sharma.

"Do we want to create a framework where regulators determine what information is relevant and appropriate for individual rating decisions?" he asked. "Or where the supervisor has to determine whether an individual rating should be changed due to changes in market conditions? What will this mean for the independence of ratings and for moral hazard in our financial system?"

Any proposed regulatory framework must not, despite best intentions, risk creating further costs, inefficiencies and disruption for the European capital market. The emerging consensus among ratings users was that any new regulation in Europe should be aligned with existing rules in other regions. As the Financial Stability Forum, the International Organisation of Securities Commissions (IOSCO), and other organisations had argued, the official approach to this issue should be co-ordinated globally.

"This is all the more significant when you consider that the Commission's proposed regime would, in practice, apply to rating agencies' operations globally, not just to those in Europe. It is worth remembering that in an earlier review of rating agencies this year, both CESR [the Committee of European Securities Regulators] and ESME, the European Securities Market Experts group, advised the Commission that a co-ordinated approach to rating agencies among regulators both within Europe and globally was required in order to avoid duplication of effort and the creation of conflicting regimes.

"We and many others believe that the best way forward for the Commission is to focus any EU oversight regime on the IOSCO code of conduct." The IOSCO code had recently been strengthened and was widely accepted by regulators and market participants worldwide as an appropriate set of standards for ratings agencies to follow.

"Europe is today the world's largest capital market, thanks in no small

part to the quality of its regulation. It has tended to avoid the trap of introducing measures in haste and avoiding unintended consequences."

There was a real opportunity in the case of rating agencies to establish a regime that worked in the interests of the European market as a whole and recognised the global impact of its decisions. A regime based on a single home regulator in the region supervising rating agencies' compliance across the European Union with internationally agreed principles and standards.

Mr Sharma said a well conceived and co-ordinated approach globally to overseeing ratings agencies could be a winning formula for the market. "But the starting point has to be international co-operation and careful consideration of all the issues and implications. We share the same objectives as policymakers in Europe to restore market confidence and stability."

Nout Wellink, Governor, De Nederlandsche Bank and Chairman of the Basel Committee, said the financial crisis may have come as a surprise, especially in its timing. But he said the weaknesses in the system were less of a surprise. "Already in December 2006, the Basel Committee identified six weak spots in the business model of banks. And it developed its new framework on the basis of that analysis. All these weak spots are well known now. They relate to accounting, they relate to valuations, they relate to arbitrage between the banking and the trading book. They relate to weak stress testing, to transparency, to disclosure, and so on. These things were known."

He said it was clear that innovation in the financial sector had outpaced risk management, regulation and supervision. "To some extent we saw it all happening. And then of course the question arises why did it happen? My feeling is that the answer is deeply rooted in human nature. In good times it is extremely difficult to convince bankers that the risks they are taking are too big. It is extremely difficult to convince politicians that it might be necessary to increase the burden of supervision."

This was also true of the public at large. Everyone tended to underestimate risks in good times. That was why there had been more than more than 120 financial crises since 1870. "This is not a new phenomenon, the new thing is that it is not a crisis in an isolated institution or in a country. It is more or less a worldwide financial crisis."

We were seeing how critical banks were to the intermediation process through the provision of liquidity to many types of markets and counterparties. Insufficient capital and liquidity buffers raised the risk that large losses at banks could disrupt the credit process. "We now find ourselves in a delicate situation with the real risk of a negative feedback spiral.

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“What is becoming increasingly clear is that over time the banking system needs to raise its buffers to withstand prolonged periods of stress in the financial system and the global economy. It is critical that we increase the margins for uncertainty in the system. It cannot be in our interest to have such tremendous cycles of bust and boom, exacerbated by leverage.”

He said the Basel Committee would contribute to the efforts to increase the margins for uncertainty. “We will take into consideration that any actions need to be phased so as not to aggravate near-term stress, at the same time as preparing the system better for the next shock.” The Committee will soon propose enhancements to the minimum capital requirements under Pillar 1 of the Basel II framework. It is also developing enhanced guidance under Pillar 2 for the supervisory process and proposals for disclosure requirements under Pillar 3.

Increasing banks’ liquidity cushions and improving supervision had been another area of focus for the Committee and Mr Wellink expected to publish the basic principles of supervision shortly after the conference (NB the Basel Committee’s liquidity guidance was published on 25 September).

He recognised that pro-cyclicality was a very serious issue. “Pro-cyclicality, to some extent, is part of human nature. What goes up must come down.” Dampening pro-cyclical elements had always been the intention of Basel designers. “Whether we have been successful enough we can only assess after its full implementation. The issue is high on the agenda; we have an analytical framework and we are waiting for incoming data.”

Meanwhile, the financial stability forum had established a group, chaired by Mr Wellink, that has three working parties to deal with the issue of procyclicality, looking at:

- 1) Evaluation and leverage
- 2) Capital, pro-cyclicality and provisioning,
- 3) Remuneration

Tommaso Padoa-Schioppa, Former Italian Minister of the Economy and Finance, posed the question: have we have learned things we did not know before the crisis, or have we had things we knew already confirmed?

He was more inclined towards the first hypothesis. “I lean towards the idea that this crisis was in many respects a normal crisis. It did not exhibit things that were entirely new and that require a fundamental change in existing approaches.”

Some points for action were already clear, concerning monetary policy, the independence of agencies, rescues and bailouts, and the role of politicians on the public policy side.

On monetary policy, he said a key determinant of the crisis was an under-evaluation of risk, as a consequence of an over-abundance of liquidity. With abundant liquidity, the search for yield was inevitable, meaning that asset prices were increasingly detached from a proper evaluation of risk.

“My generation has seen monetary policy becoming independent of political instructions and strongly focused on price stability. Price stability has been safeguarded not so much by tight money, but by a learning of behaviour by wage earners and unions after the long inflation of the 70s and 80s; and by the price dampening effect of really low prices of manufacturing goods coming from Asia. This has left monetary policy dangerously free to expand liquidity without seeing the natural consequence, that prices start moving up. The prices that started to move up were asset prices. The question here is what are the lessons to be learned for monetary policy from this experience? This is an agenda for investigation rather than action.”

On the independence of agencies, he said the issue today was more about independence from markets than from politics. “Policymakers are very reluctant to be unpopular with markets. They feel strong enough to be unpopular with politicians because they have strong statutes, but to say something that the market doesn’t heed is very difficult. Independence has shifted from the political to the market interlocutor. If agencies and central banks were at some point nationalised and made dependent on politics, it was to make them independent from the markets. Are we going back to where we were before the era of the nationalisation of the banks?”

On rescues and bailouts, he said that in spite of the arguments regarding moral hazard, there were circumstances in which they are necessary. “The question is, if extraordinary action is taken, what should be the principles that should also hold for these extraordinary actions? My sense is that there should be no mercy for managers and shareholders. I don’t see any social reason why these two principles should be forgotten. What is necessary is to protect other stakeholders.”

On public interest, he said something should be done at the political level before governments are called upon to bail out financial institutions.

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