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“The true crisis is the crisis of incompetence”
Albert Einstein, 1955

GLOBAL FINANCE, REGULATION AND SUPERVISION
IN THE LIGHT OF THE DE LAROSIERE REPORT

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1. The Global Financial System (GFS) and the myth of self-correction and self-regulation.

- The GFS is a world-wide integrated dynamic innovative network of interactive components: intermediaries, securities (products), markets, derivatives, regulation and supervision.
- The analytical and policy mistake at the turn of the New Millennium was to believe that financial innovation and “technical” market efficiency (information, allocation, stability) implied a fundamental break with the past (the New Economic Era), and notably that:
 - (i) markets became self-correcting, market failures became irrelevant; financial markets were more efficient than intermediaries in assessing and managing risks (complete and efficient markets);
 - (ii) intermediaries, intrinsically based on asymmetric information and delegated monitoring, had, in any event, developed very potent risk management and control techniques; hence the paradigm of (short-term) shareholder value creation;
 - (iii) self-regulation of intermediaries and markets could be relied upon with great confidence;
 - (iv) innovative financial structures created by investment banks and based on highly complex statistical/probability models and on derivative instruments represented a highly positive and efficient development not to be hindered (even if they were directed to regulatory, supervisory and tax arbitrage);
 - (v) the capital standard for regulated intermediaries (banks and insurance companies) was a pillar change (the New Corner Stone) for regulation and supervision;
 - (vi) monetary stability (measured by core consumer price inflation) was the anchor of financial stability.
- The lessons of 2007/09 show that all the above points contained some grains of truth, but were fundamentally wrong:
 - (i) markets are not self regulating, but, as in the past, are always prone to speculative bubbles;
 - (ii) the advances in risk management were flawed because of the inappropriate treatment of the assumptions behind the underlying models, based on derivative stochastic models, which replaced traditional actuarial models (VaR models are a clear example). Even the assumption of independence between the government risk free rate and the private risk premiums must be questioned. Additionally, flawed corporate governance models did not allow adequate checks and balances between risk takers and risk controllers;

- (iii) the workings of the GFS requires good regulation and effective supervision, also as a result of its important and wide range externalities. The Basel capital standard, the IASB accounting standard and the credit rating agency approach were instead affected by fundamental weaknesses, notably their procyclicality; this is partly related to the analytical framework just described (as evidenced by the very high leverage ratios reached by many “well capitalized” European banks in the upward face of the cycle) ;
 - (iv) beyond regulation and supervision, sound and sustainable economic policies are required to contain market failures and to control cyclical developments. Here again the false myth that “the cycle is dead” was exploded;
 - (v) the functioning of the global financial system requires consistent supervisory, regulatory and economic policy frameworks (and hence strong cooperative arrangements) among major countries;
 - (vi) price stability does not lead automatically to financial stability.
- In sum, a fully developed GFS is very sensitive and therefore potentially unstable.

This is, by no means, a novel conclusion, but the lesson was largely forgotten in the past decade, when recognising the fact of that instability was regarded both an analytical and a policy mistake. The contrary view that the system was fundamentally self-correcting, through competition and an invisible hand approach, had become the (nearly) common wisdom.

If the main factors underlying the crisis are seen in this perspective they are clearly not independent, but result instead from the same mould of analysis. In terms of this unitary framework we can both review the critical assessment offered by the de Larosière Report of the main underlying failures behind the crisis and the proposals for global repair in a holistic and complementary way.

In the following sections 2 (failures) and 3 (repair), I will adopt this approach and offer a rereading of the Report, with a different order of presentation, with a view to focusing on the links between macroeconomic policies, regulatory and supervisory actions and market repair.

2. The main failures behind the crisis¹

2.1. Macroeconomic policy failures

- Excessive liquidity and credit creation; insufficient attention to the housing bubble in the US (§ 6-7)
- Global imbalances in financial and commodity markets and in saving/investment/current account trends (§ 8-12)

2.2. Market failures

- Corporate governance (§ 23-24)
- Risk management (§ 13-18)
- Credit rating agencies (§ 19-22)
- Securitized products and derivative markets (§ 93-95)

2.3. Regulatory, supervisory and crisis management failures

- Insufficient attention to liquidity of markets (§ 26)
- Inappropriate capital adequacy measures and accounting standards and inefficient treatment of securitisation processes (§ 25-53/65/73-79)
- Insufficient multilateral surveillance (§ 31)
- Incomplete framework to deal with crisis prevention, management and resolution, and inadequate burden sharing arrangements (§ 28/125-143)

2.4. The missing link: micro vs. macro prudential supervision

- The nature of the problem (§ 145-151)
- Excessive focus on micro prudential supervision of individual financial institution, and insufficient attention to the macro-systemic risks of contagious, correlated, horizontal shocks (§ 27-30)

3. Global financial repair: actions to overcome the crisis and to prevent the repetition of major systemic breakdowns

3.1. Surveillance of Macroeconomic Policies and Crisis Prevention (§239-252)

3.2. Crisis Management and Resolution (§ 253-255)

3.3. Regulatory consistency and cooperation among supervisors (§ 224-238)

¹ For obvious reasons of space I will not report here the text of the paragraphs to which reference is made.

3.4. Market Repair:

- Internal Risk Models and the Capital Standard (§ 53-65/122-124)
- Credit Rating Agencies Reform (§66-72)
- Corporate Governance & Checks and Balances between risk takers & risk controllers (§ 110-121)
- The activities of the “parallel banking system” (§ 85-98)

3.5. The role and function of the EU in the new global financial architecture:

- European Systemic Risk Council (ESRC) (Macro Prudential) (§ 167-189)
- Towards the creation of a European System of Financial Supervisors (ESFS) (Micro Prudential) (§ 190-218)
- European Governance at global level (§ 256-257)

4. After the Report: two additional lines of action

4.1. Cleaning banks’ balance sheets: the toxic assets issue and the need for a cooperative European approach

To restore confidence and functionality to the financial and economic system, and to stop the free fall in the global economy, it is vital to reduce uncertainty on the banking system.

Recapitalisations and government interventions have succeeded in avoiding the meltdown of the system, under very difficult conditions.

But doubts linger on and the risk of a fall-back is high.

How could it be otherwise if, according to the IMF, aggregate global losses of the financial sector and of the banks continue to rise to staggering figures, apparently with no end in sight, even if the impact of cyclically-related “traditional” credit losses is still relatively limited?

According to the latest Global Financial Stability Report (April 2009), the IMF currently indicates that aggregate financial losses could mount to \$ 4 trillion, of which some \$ 2.7 trillion would be incurred directly by banks.

Available figures show that only some \$ 1.2 trillion of bank writedowns have been disclosed so far on a world-wide basis; thus, some \$ 1.5 trillion losses are still on the way.

In order to put these figures into perspective, let us recall that total fresh capital injections since the outbreak of the Great Financial Crisis can be estimated in the

region of \$ 1 trillion, with approximately half of that amount coming from public money.

A major source of concern is also related to the fact that the IMF estimates of the losses are continuing to rise. In October 2008 they were put at \$ 1.4 trillion, in January 2009 they had climbed to \$ 2.2 trillion, and, as indicated, they stand, three months later, at \$ 4 trillion.

No doubt markets remain skeptical and the ghost of major future bank insolvencies continues to haunt markets and policy makers!

A curious dichotomic approach has developed: as the official estimates mount, policy makers, supervisors and bankers act as if the projections were exaggerated, without, however, embarking in a fact-finding exercise, and de facto adopt a wait-and-see attitude. Strauss-Kahn went as far as suggesting that policy makers are tempted to sweep the problem under the carpet!

The pros and cons of full transparency are hard to assess, but I would suggest that this exercise should be undertaken, to cleanse banks' balance sheets and to fix the financial sector.

The United States President Obama and Treasury Secretary Geithner have decided to move in this direction, unveiling a comprehensive plan on March 23, at the White House, and the market response was very positive; the Plan is different from the initial Paulson proposals (which were sometimes referred to as "cash for trash"). In Europe it is more difficult to act rapidly in a coordinated way. Country situations differ significantly, and, above all, the issues of burden sharing and (national) taxpayers money represent objective obstacles.

The reasons why I would press action are manifold:

- (i) to start with, this is a clear case of macroprudential oversight: the available estimates point to a major continuing threat to the viability of the system, which requires corrective action (detoxication);
- (ii) a coordinated European response, based on national initiatives, but attentive to the problems posed by major cross-border banks, is the necessary counterpart to the Treasury plan in the US;
- (iii) the very fact that "toxic assets" are kept within the banks and thus poison the financial system is hard to accept;
- (iv) this transparency operation, if properly engineered and coordinated, could well reserve positive surprises.

Let me briefly develop this last, more important, point.

To start with, the term "toxic assets" is misleading and should be abandoned: not only the words suggest that the assets are, at best, unrealised writedowns in opaque balance sheets, but also convey the impression of poison running through the system, with disease and contagion repercussions.

Truly "toxic" assets, sometimes referred to also as nuclear waste, should therefore be identified, isolated and buried away - especially when dubious operations with offshore centres are involved - thereby cleansing balance sheets.

But I have good reasons to believe that, in Europe, a part of these assets is simply illiquid, and very difficult to evaluate under current conditions of continuing “market failures” in financial markets and of great uncertainties on the prospects of the global recession.

According to recent Moody’s estimates, the average recovery rate of unsecured bonds is in excess of 50%, while their prices are well below recovery rates.

Fair value and mark-to-market techniques can hardly be applicable under current deeply negative and uncertain conditions. Many of these structured non-standardized were built to be held until maturity. In any event, it is vital to distinguish between mark-to-market losses and expected credit losses (present values of expected cash flow until maturity). Always according to Moody’s estimates based on a large sample of impaired assets, while m to m values come to some 20% of book, expected credit losses are one-third of nominal values.

The exercise of transparency and separation of these assets within the framework of special PPP’s (private public partnerships) can therefore be rewarding, with a view to repairing banks’ balance sheets, improving capital ratios and restoring lasting confidence. The double move of the ECB to buy covered bonds and to lower interest rates is very positive.

This is not the occasion to enter into technicalities and to debate the new US plan. Let me simply indicate two available options in Europe, which the banks themselves should assess in the first place:

- (i) Spin off: the bank creates a SPV with VVAs (variable-value assets) and related liabilities. The vehicle is demerged to existing shareholders and open to new investors (Public Funds, Private Equity Funds, Sovereign wealth Funds);
- (ii) SPV refinancing: the bank transfers at book value the VVAs to a SPV created by the Government(s), which issues corresponding bonds. The bank pays guarantee fees to the vehicle, the fees may imply the issue of fresh capital reserved to the government.

In both instances, a screening of assets would be conducted by independent teams of experts and a newly created EU “Stabilisation Fund” should be a complementary player, also with a view to ensuring that a level playing field is maintained, no “national champion” lures are followed, and home and host countries fully cooperate if bank recapitalisations prove necessary.

Let it be stressed that, from a macroprudential point of view, it is very clear, at least to me, that recapitalization and troubled assets recovery of banks must take place simultaneously.

4.2. Reopening the securitisation process

Securitisation is, in principle, a highly positive development of the past three decades.

The excesses and risks connected to synthetic securitisations and abuse of OTC derivatives and of OtT practices should not make of us oblivious of the need to reactivate the securitisation market, also to avoid that the burden of financing the economy falls exclusively on capital constrained banks.

Suggestions along these lines have been made, for instance, by the Chairman of the FSF Mario Draghi. A novel approach could be based on the pooling and securitisation of new credits. The securities should be appropriately screened and could be sold to the markets with government guarantees on senior tranches. Here again, the banks would pay appropriate guarantee fees. The EIB and the EC could play an important role in this area, drawing upon their experience in the LGTT (Loan Guarantee Instrument for Trans-European Transport Networks). The innovative financial instrument has been devised to facilitate greater participation by the private sector in the financing of TENs, by reducing the risk profile for senior lenders.

5. Concluding remarks

- (i) There is the need to abandon false myths and to ensure a “cultural” change and an adaptation of “mainstream economics”: the operation of the GFS requires good regulation and supervision, and appropriate corporate governance models.
- (ii) The problem is not to have more regulation, and to stifle innovation, but that of creating rapidly a better regulatory and supervisory framework at global level: the de Larosière Report represents a comprehensive blueprint for swift action.

- (iii) Enhanced cooperation and global surveillance on macroeconomic policies are also required: important roles should be played by the IMF and by the EU.
- (iv) The issues of “detoxication” of banks and of reopening the securitization process call for immediate attention in Europe.

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