

EPFSF Lunch Discussion

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Financial Turbulence, lessons to be learned

**Summary of Speech from Francesco Giordano,
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After the 'originate-to-distribute' model, what next?

Rationale for its development

Over the last thirty years, regulatory initiatives in the financial sector have spurred market openness and banking consolidation along with higher risk taking. That went together with progressive banking disintermediation and the increasing weight of the financial sector. Among the main consequences of increasing competition and banking disintermediation, one can trace: 1) declining lending margins and 2) increasing funding gap and widespread recourse to securitised lending (the so called OTD model).

There are several advantages for both originators and borrowers of this type of business banking model. Among the benefits for banks one can consider: higher lending capacity, lower funding cost and higher opportunities for risk sharing. Moreover, return on economic capital rises. Overall for investors markets are more complete and the range of tradable assets rises, implying a wider investment opportunities menu and, in principle, a better risk allocation. On the borrowers' side, for corporates in particular, there are higher financing opportunities and lower funding cost, opportunities to better manage key risk exposures. In general, securitisation has increased credit access for impaired consumers.

What did go wrong?

The recent turmoil has made the risks entailed in the OTD model more material and tangible. A number of weaknesses in the financial infrastructure, which might importantly weigh on investors' and market confidence, has come to light. First, many of the assets, that has moved from banks to securities markets, turned out to be excessively opaque. Lack of transparency and length of the securitisation chain implies uncertainty on the ultimate bearer of credit risk. Secondly, the misuse of the OTD model led to an excessive risk transfer to unregulated intermediaries. Many banks ended up providing increasing liquidity to captive, unregulated and highly leveraged institutions. Thirdly, following the August turmoil, the widespread loss of confidence and increasing risk aversion has produced a liquidity dry-up and a severe increase in the banks' cost of funding. Such events have highlighted weaknesses in liquidity risk management both on regulators' and bank' sides. Last but not least, once liquidity dried up, an high share of assets for which no market value can be computed materialised, thus heightening model risk (difficulty of capturing low probability events, possible mis-pricing etc.).

What next?

A severe backtracking in securitisation is under way. However, a complete return to the pre-securitisation banking model seems improbable in the medium-term. A reassessment of the banking intermediation model cannot be postponed: to avoid the risk of regulators' overreaction a more pro-active attitude of the banking industry itself is strongly required. Self-regulation initiatives might help modifying inadequate business practices and/or internal procedures/infrastructures, while new rules must be written, in close collaboration between public and private sectors, in the areas where existing ones were found lacking. Banks should increase transparency as for credit risks, financial statements, lending practices and composition and evaluation of structured products. Further development of stress testing is essential to manage liquidity risk, while liquidity rules in general must be reassessed. The road ahead: 1) the OTD model (instrumental in supporting higher access to long-term finance for impaired consumers and abundant credit to innovative corporates) will not disappear; 2) the OTD model will be significantly scaled down however; the role of banks as bearers and not just originators of risk has been reconfirmed; 3) from the industry viewpoint we need a reflection on how to leverage on financial innovation, without turning it into a game of regulatory avoidance or unhealthy risk shifting.

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