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Financial Turbulence, lessons to be learned

Speech from Freddy Van den Spiegel
Chief Economist, Fortis

Ladies and gentlemen,

For bankers and supervisors, the market situation is frightening and for politicians, the situation is a challenging invitation for regulatory initiatives. But for economists, the financial crisis provides interesting material.

My intervention today is closer to an academic approach and can therefore be somewhat provocative. It is not representing the position of Fortis or of any organization like for example the consultative panel of CEBS in which I am involved as Chair. It is a comment of an economist with a privileged position to watch the events.

Let me start with some quotes of a publication, pointing to dangerous evolutions in the financial markets, especially the CDO business, and with recommendations for those involved in the CDO business, which is at the centre of the actual problems:

- Market participants should have the capacity to understand the risks in these instruments
- Participants should have sufficient staff and expertise to understand the limitations of models;
- Participants should understand the nature and scope of ratings;
- Participants should understand the liquidity characteristics. Investors in CDO's should be aware of limitations on secondary market activity associated with such instruments;
- Market participants should continue to work to improve the quality of public disclosures;
- Supervisors should undertake steps to enhance their understanding of market developments;
- Supervisors should continue efforts to share information about these products.

Where are these quotes coming from and when was this report published? No, this is not a recent report after the summer 2007. It is the report of the Joint forum of 2005 (this is before the volumes became out of control), reporting to the FSF, and to the G7. This is rather a disturbing finding: already in 2005, politicians, supervisors and industry were aware of what was happening. There was no problem of transparency. Supervisors were warning, and the BIS was publishing the increasing volumes.

But the key question is: Why the stakeholders, knowing what was happening, did not change their behaviour? Probably because they had an incentive not to react. Politicians preferred to continue the artificial growth of the economy, essentially the US economy, even if it increased unsustainable imbalances. Supervisors had no incentive to intervene, and the industry was busy making money, while all knew what was happening

If we are serious about finding solutions to reduce the risk of a next crisis of the same nature, we should recognize this reality and look for the fundamental problems, instead of fighting lots of symptoms with supplementary regulatory burden that potentially could be counterproductive.

The FSF report identifies more than 60 problems where regulatory initiatives are needed. This could suggest that probably everything in regulation or supervision was wrong. I would like to make a distinction between fundamental issues and the more continuous "fine-tuning" needs of the regulatory framework.

I am not claiming to have identified the key fundamentals, but this is how I would describe the chronology of the crisis and prioritise the problems:

- The first problem is lending standards or massively giving aggressive loans: bad loans never turn into good investments;
- Second the risks of these bad loans were transformed into excellent quality investment, using the confidence of ratings, which allowed the risks to be taken by "the prudent man"
- Third, there was a complete underestimation of liquidity risks by industry and supervisors;
- Four, IFRS accounting rules force banks to bring the panic reflected in market prices in their reporting, leading to unnecessary stress in the banking system.

If there would be an agreement on these – or other – basic underlying factors, tailored reactions, focused on the future can be identified.

If we accept for a moment the previous analysis, it would lead to the following reactions:

The first problem of bad loans, or underwriting standards is in this case linked to the critical situation of an over indebted US economy with 9000 bn of net external debt. Reducing this imbalance should be a priority objective. Given the situation, the need for regulatory intervention can be assessed from different angles: consumer protection to avoid over indebtedness of households, correct risk management if regulated institutions like banks are involved, and financial stability issues if the volumes become a threat to financial stability. Consumer protection is an important debate but has directly nothing to do with the crisis. Prudential aspects should be reviewed, but this can be considered as ongoing fine-tuning within the existing CRD framework. I would say that today, essentially the macro prudential dimension or financial stability is a problem.

The issue is fundamentally linked to the architecture of financial safety networks: Who is in charge of financial stability, is it acceptable to stop bubbles to grow, and what are the tools available to intervene before a bubble becomes too big? If central banks are the natural supervisor for these issues, we should take into account that in general they have been reluctant to intervene to stop bubbles from getting out of control, and furthermore, there is not a clear toolkit available, like that which is available for monetary policy. There are lots of "stability reports", indicating risks and imbalances, but there, the story ends. Organising this dimension of the financial architecture is urgent. It necessarily takes into account the activities of the non-regulated financial institutions. The Blueprint of Paulson in the US is interesting, but Europe has to make up its mind. Probably a "wise men committee" to look at the whole financial architecture in the EU would be helpful.

The second problem is the role of ratings. They allowed the risks of bad loans to be spread around the world, given excellent ratings of the securitized products. More transparency or codes of conduct can perhaps be of some help, but the fundamental issue is blind faith of professionals in rating agencies, which is encouraged by the "pseudo regulatory" role that rating agencies have, like in the CRD framework. More regulation on rating agencies will increase the moral hazard. The way forward should be to reduce the role of rating agencies, by recognizing that they only give "an" opinion about certain aspect of risk, and never an officially approved risk assessment.

The third problem, market liquidity, came as a surprise to everybody: markets were considered to give always "rational" prices and transaction opportunities. Basel 2 had postponed the treatment of liquidity risks, wich gave the signal that this issue was not that urgent. CRD took over the same approach. The banking industry considered that transforming long term assets into short term funded commercial paper, using Conduits or SIV's, was not a significant risk. Knowing the history of banking since the middle ages, everybody should have known better. The recognition that liquidity is extremely vulnerable leads to a need to have a regulatory framework, which also respects the level playing field. But as important is to monitor in which way the industry has learnt its lesson and is self correcting. The actual liquidity crisis is probably an indication that the industry is even overreacting. In that case, the development of regulation should be done with care, and adding more stress on banks now could have severe negative effects on the economy.

The fourth problem is that accounting or reporting rules, based on IFRS, assume that market prices, in almost all situations, give the best approach of "fair value". Reduced liquidity or panic is not accepted as an argument that market prices do not reflect "fair value". The result is that banks have to struggle with unreasonable market prices were most analyses (OECD, BOE) agree that they do not reflect economically reasonable fair value. But the effects on the banking system in terms of stress and the consequences on the economy as a whole can be potentially disastrous. Banks, having to accept depressed market prices reflecting panic, reduce their solvency in an artificial way. The consequence is that their capacity to lend is reduced, and this leads naturally to a credit crunch. The procyclicallity of IFRS, combined with Basel 2 is there in all its glory. A fundamental debate on this issue seems urgent.

Finally, let me close with some positive elements. Big banks in the EU have been in general quite resilient. They have lost, but not to the extent that their basic solvency is threatened. The prudential regulatory framework has so far worked quite well. Banks that got into severe problems were characterized by extreme business models and fundamental problems of corporate governance. Models, in general, gave the right indications, be it sometimes rather late. And everybody agrees that earlier CRD/ Basel II implementation would even have avoided some of the problems of today.

This however does not mean that all risks are under control. The EU banking market is increasingly integrated. This is no longer a political agenda, it is a fact. Logically, the framework for supervision and crisis management should reflect this reality. Efficient and effective supervision of financial institutions active in this integrated market is only possible in a coherent EU supervisory framework. This requires a strengthening of the supervisory coordination at EU level, combined with an extended focus on group supervision.

If this crisis leads to more political courage to make progress on this obvious issue, it will at least have some positive result.

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