What have we learnt from the financial crisis?

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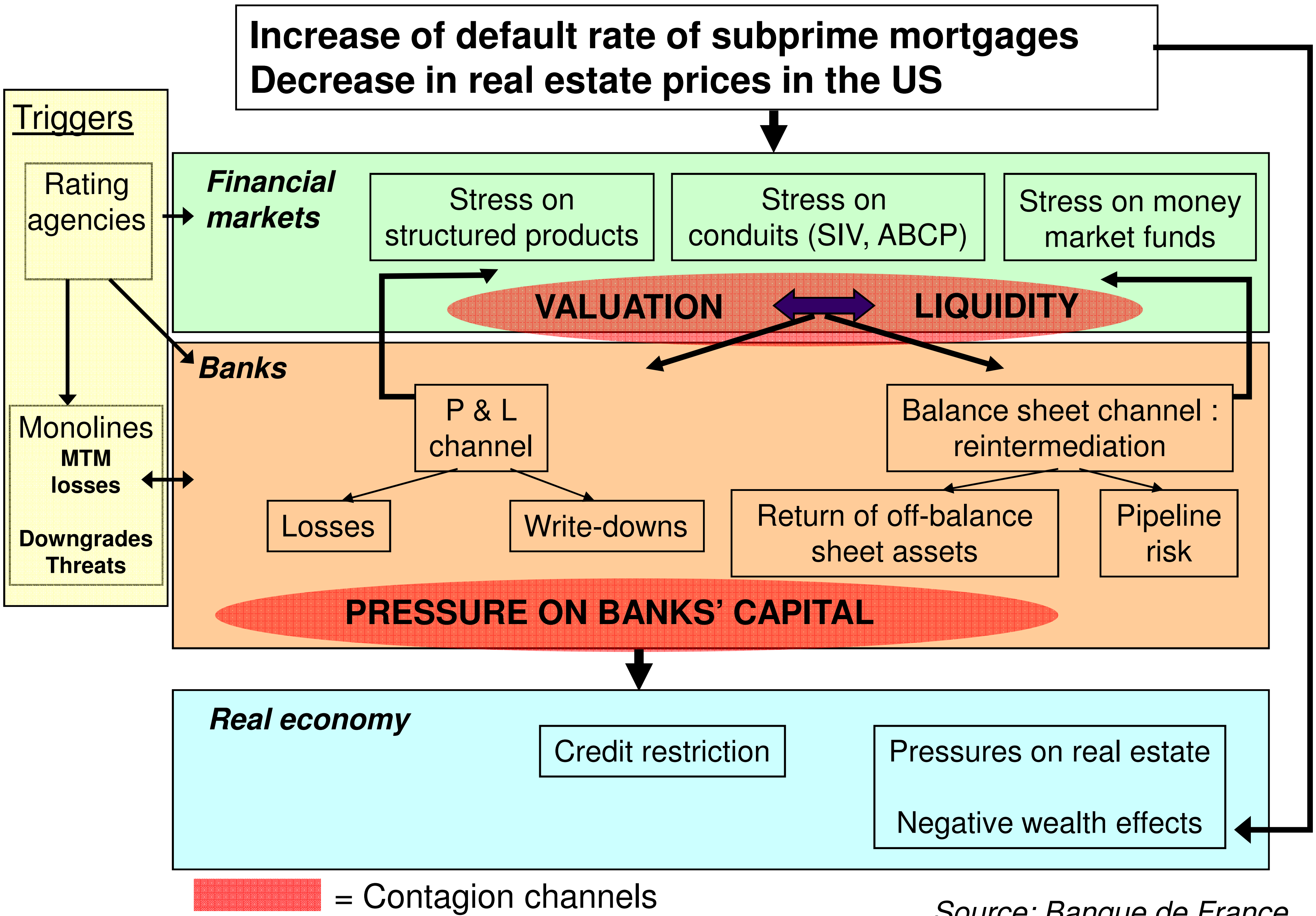
Issues

1. What we have been through
2. Lessons learnt
3. Actions taken
4. The way forward

1. What we have been through

- Cross-market spillovers: from a housing market crisis to a mortgage, then to an interbank liquidity crisis
- Cross-border spillovers: from a (regional) US crisis to a global shockwave
- Spillover to the real economy is tangible in the US but surprisingly muted so far in the Euro area



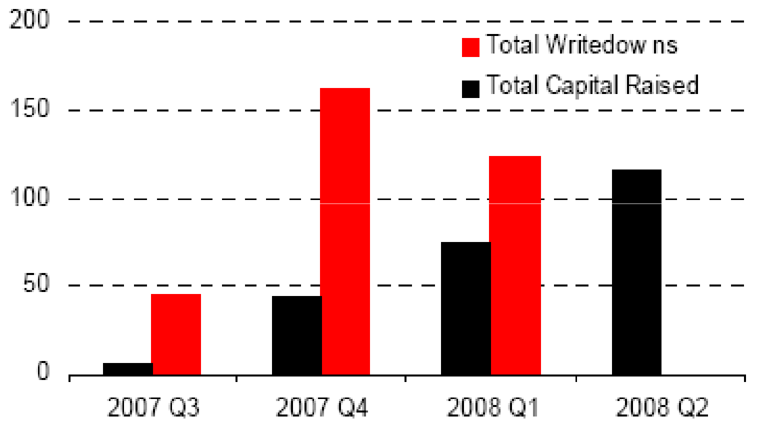
Source: Banque de France

De-leveraging and capital injections still needed

- Process is well under way but will be long and will have adverse economic consequences
  - Lower bank profitability, depressed stock prices
- Recapitalization needs higher in the US due to need to recreate bank loans portfolios to subsistute for securitized credit?

Magnitude of de-leveraging and capital injections

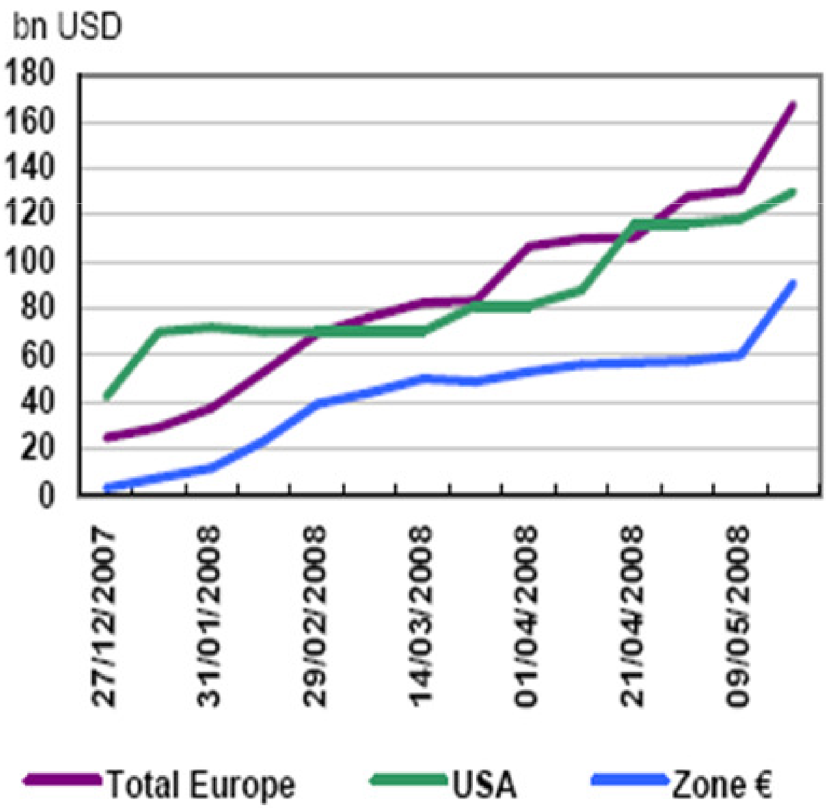
Write-downs and capital raising



Earnings for 2008 Q1 not full. Capital raised in Q2 2008 is through May 14

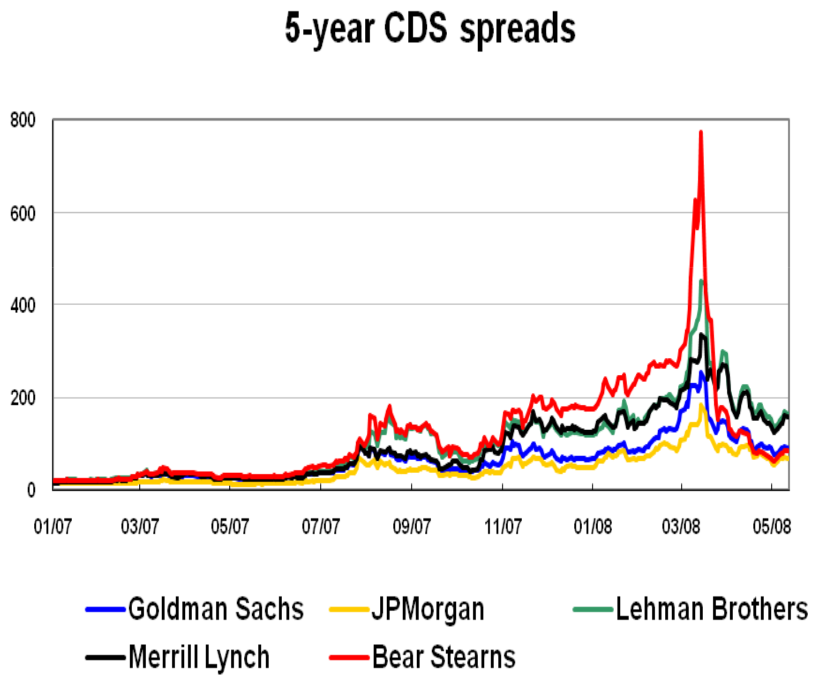
Source: SG

Write-downs in the US and Europe



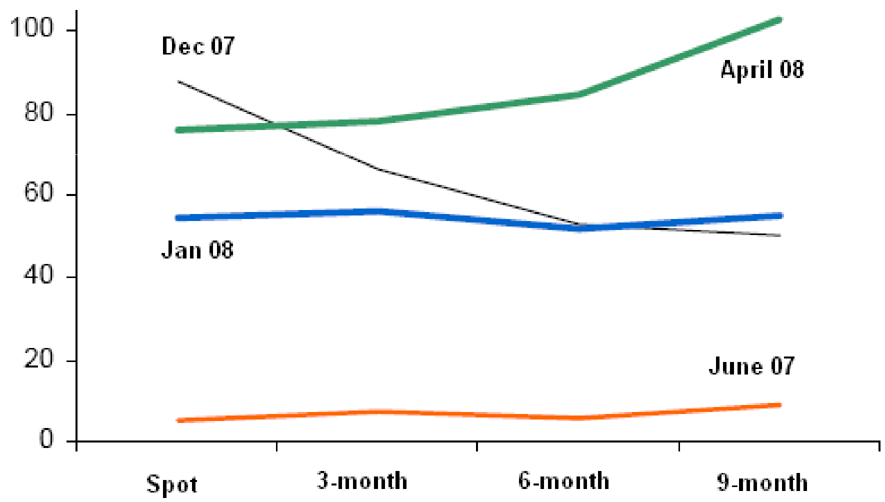
Light at the end of the tunnel?

Yes: Normalization under way



No: Crisis still unfolding

Euro area Euribor-OIS spreads



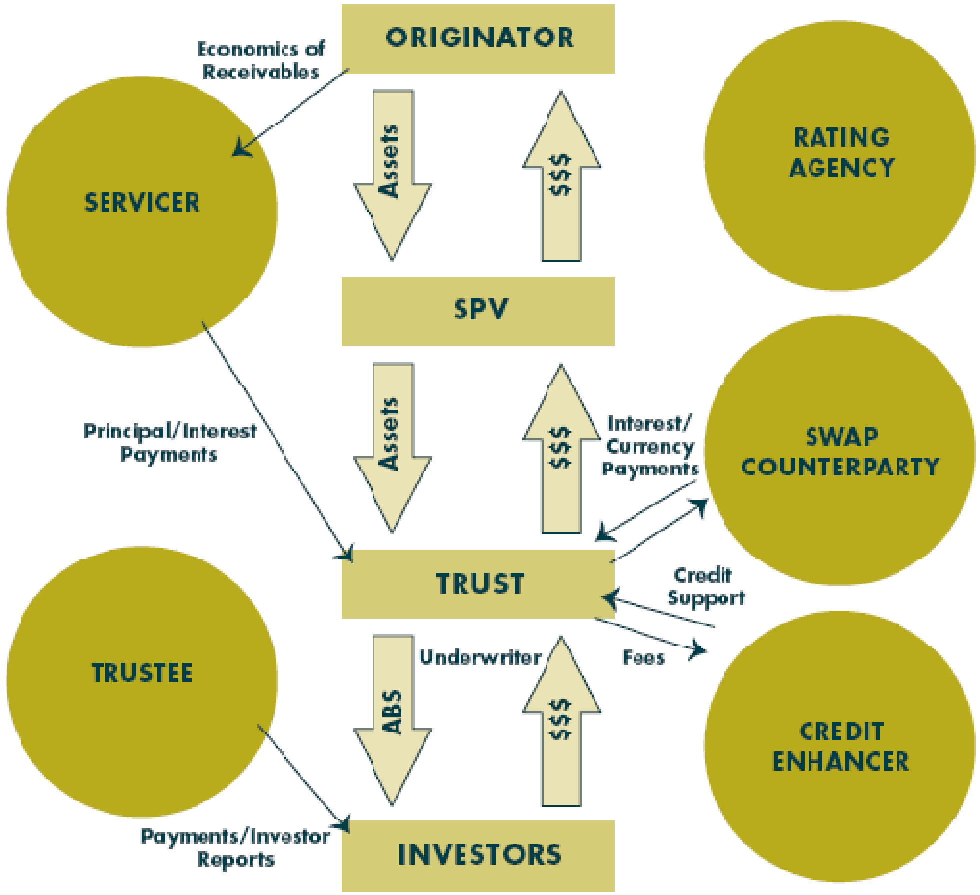
Source: Banque de France

Source: BNP Paribas

2. What have we learnt?
(i) Structured products

- Flaws uncovered in business model of US mortgage origination
- Insufficient due diligence along the supply chain of ‘toxic’ products
  - Incentives for investment banks to underwrite high-margin, risky products, and dispose of them promptly
  - Loose validation by rating agencies with lack of incentives to stand on investors’ side
  - Investor illiteracy and/or lack of information
- Valuation based on illiquid markets, poorly correlated indices, and more often than not on no market at all

The securitization chain

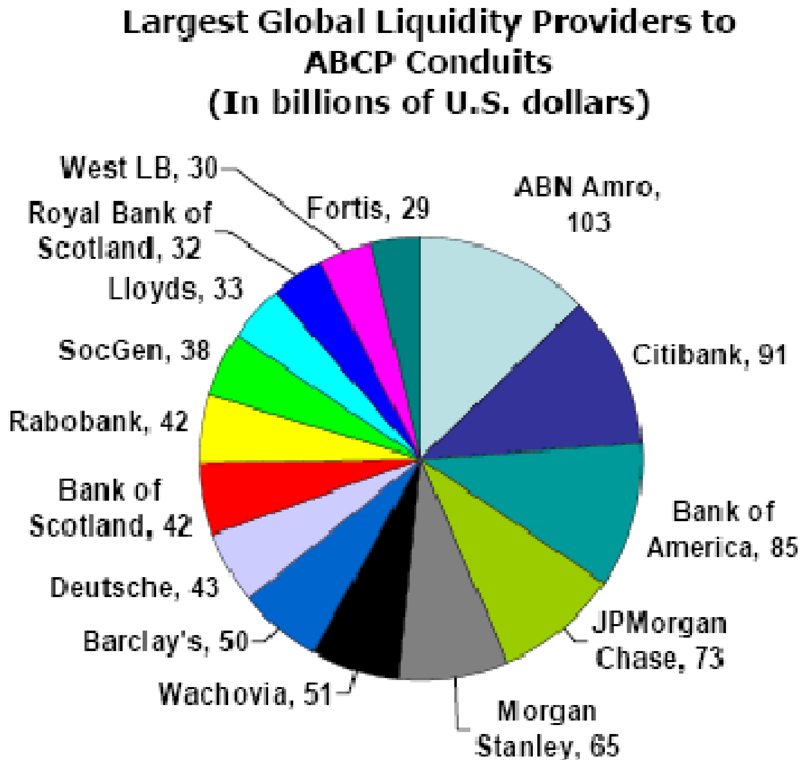


Source: European Securitisation Forum

(ii) Liquidity

- Magnitude of conduit-based finance was known but risks were overlooked
  - Risks arising from maturity transformation
  - Excessively narrow focus of bank regulators on on-balance liabilities
  - Vulnerability of conduits due to lack of access to central money
- Sticky liquidity flow throughout the financial system
- Possibility of ‘sudden freeze’ of interbank liquidity was not anticipated

The Hidden $800 Bn



Source: Standard’s and Poor

(iii) Market interlinkages

- Examples taken from the 2007/2008 episodes:
  - Spillover of liquidity tensions from USD to EUR interbank market
  - Spillover of market dislocation from interbank to repo, then bond market
  - Fire sale of assets by strained global investment banks
  - Expected contagion from US to European housing markets
- New contagion mechanisms compared with 1990s crises

(iv) Regulation

- Crisis (ironically) did not burst in the hedge-fund segment but in ‘mainstream’ investment banks, SIVs and monolines
- Obstacles to liquidity distribution into the financial system were uncovered
  - Drawbacks of ‘Glass-Steagal’ wall between commercial banks and investment banks
- Heterogenous regulatory practices
- Insufficient oversight of structured credit underwriting and of prime brokerage?

What about transmission channels?

- European GDP growth has resisted relatively well so far
- Predicted collapse of European housing markets has not occurred
- Capital expenditures have survived the dislocation of conduits, expensive Euribor, and widening of corporate financing spreads
- Emerging market economies have been fairly decoupled so far
- But will this last under tighter monetary conditions?

3. Actions taken

(i) Increased flexibility of monetary frameworks

- Unprecedented, coordinated liquidity supply by major central banks
- Maturity extension of repo facilities
  - Supplementary 3-month and 6-month operations introduced by the ECB
- Widening of eligible collateral basket
- Widening of eligible counterparties
  - New Fed primary dealer window
- ECB collateral basket and eligible counterparties list did not need to be modified, being very large from inception

(ii) Prompt policy reaction

- August '07 G7 mobilisation (e.g. Sarkozy letter)
- Nov '07 Ecofin roadmap
- March '08 US President Working Group on Financial Markets
- April '08 Financial Stability Forum action plan, including 'first 100 days' priorities:
  - Risk disclosure by banks
  - IASB work on accounting standards for off-balance sheet entities and valuation of assets on illiquid markets
  - Basel Committee work on stress-testing ans capital planning under Pillar II and on liquidity risk
  - IOSCO guidance on credit rating agencies (integrity of rating process, conflicts of interest, investor information)

- Common principles:
  - Strengthening market discipline
  - Modifying approaches of credit ratings agencies
  - Improving transparency and valuation standards
  - Reviewing banks' risk management practices

The ECOFIN roadmap (November 2007)

- Enhanced transparency for investors, markets and regulators
- Improved valuation standards
- Reinforced prudential framework, risk management and supervision in the financial sector
- Improved market functioning, including the role of rating agencies

France's EU presidency work programme

- Responsibility
  - Basle 2 revision to clarify liquidity and securitization rules
  - Consistent implementation of European law
  - Full implementation of ECOFIN roadmap
  - Common approach to sovereign wealth funds
- Modernization
  - Solvency 2
  - Harmonized measure of bank equity
  - Supervision of cross-border groups
  - Common passport for UCITS
- End-user protection
  - Bank account transferability
  - Single market for retail financial services (e.g. mortgage credit)
  - Single euro-area payment area

4. The way forward
(i) Rethinking global regulation

- Open questions
  - Did regulatory competition (e.g. between London and New York) contribute to excessive risk-taking by financial institutions?
  - Is global regulation desirable? Is it feasible?
- Middle-of-the-road answer
  - Intensify cooperation between central banks and between supervisors
  - Standardize structured products and disclosure practices
  - Improve transparency on exposures, losses and valuation process in an homogeneous way (e.g. FSF 'common reporting framework' for banks)
  - Address loopholes in regulatory framework
    - Access to central money should imply full implementation of Basel II and ongoing supervision
- Will the FSA model survive?

(ii) Rethinking accounting standards

- Calls for termination of fair value are undue
- But flaws of mark-to-market valuation on illiquid markets should be promptly addressed by IASB
- Reflection needed on ‘buffers’ to hoard assets when liquidity is strained
  - Caution on moral hazard, risk of micro-management by regulators
  - Failure of M-LEC ‘super-SIV’ project not a good omen
- Reflection needed of procyclical consequences of accounting/prudential framework

(iii) Rethinking the financial industry

- Vibrant financial industry no longer seen as unequivocally good for economic growth
  - But not an excuse to come back to iron age of finance!
  - Sophisticated financial markets needed to face 21st century challenges, such as climate change, high and volatile food prices, old-age care, etc.
- Investment banks have to redo their business model, but only their shareholders and customers can tell them what to do
  - Compensation structure (e.g. base and time horizon of bonuses)
  - Conflicts of interest within rating agencies
- Governments should set incentives right *if* private sector does not act

Appendix. FSF Report to the G7, April ‘08

Strengthened prudential oversight of capital, liquidity and risk management

- Capital requirements: Specific proposals will be issued in 2008 to:
  - Raise Basel II capital requirements for certain complex structured credit products;
  - Introduce additional capital charges for default and event risk in the trading books of banks and securities firms;
  - Strengthen the capital treatment of liquidity facilities to off-balance sheet conduits.

  Changes will be implemented over time to avoid exacerbating short-term stress.
- Liquidity: Supervisory guidance will be issued by July 2008 for the supervision and management of liquidity risks.
- Oversight of risk management: Guidance for supervisory reviews under Basel II will be developed that will:
  - Strengthen oversight of banks' identification and management of firm-wide risks;
  - Strengthen oversight of banks' stress testing practices for risk management and capital planning purposes;
  - Require banks to soundly manage and report off-balance sheet exposures;
- Supervisors will use Basel II to ensure banks' risk management, capital buffers and estimates of potential credit losses are appropriately forward looking.
- Over-the-counter derivatives: Authorities will encourage market participants to act promptly to ensure that the settlement, legal and operational infrastructure for over-the-counter derivatives is sound.

Enhancing transparency and valuation

- Robust risk disclosures:
  - The FSF strongly encourages financial institutions to make robust risk disclosures using the leading disclosure practices summarised in Recommendation III.1 of this report, at the time of their mid-year 2008 reports.
  - Further guidance to strengthen disclosure requirements under Pillar 3 of Basel II will be issued by 2009.
- Standards for off-balance sheet vehicles and valuations: Standard setters will take urgent action to:
  - Improve and converge financial reporting standards for off-balance sheet vehicles;
  - Develop guidance on valuations when markets are no longer active, establishing an expert advisory panel in 2008.
- Transparency in structured products: Market participants and securities regulators will expand the information provided about securitised products and their underlying assets.

Changes in the role and uses of credit ratings

- Credit rating agencies should:
  - Implement the revised IOSCO Code of Conduct Fundamentals for Credit Rating Agencies to manage conflicts of interest in rating structured products and improve the quality of the rating process;
  - Differentiate ratings on structured credit products from those on bonds and expand the information they provide.
- Regulators will review the roles given to ratings in regulations and prudential frameworks.

Strengthening the authorities' responsiveness to risks

- A college of supervisors will be put in place by end-2008 for each of the largest global financial institutions.

Robust arrangements for dealing with stress in the financial system

- Central banks will enhance their operational frameworks and authorities will strengthen their cooperation for dealing with stress.