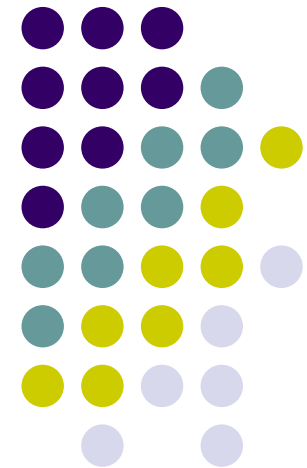


What have we learnt from the financial crisis?

Benoit Cœuré
**French Ministry of the Economy,
Employment, and Industry**

ASEM Conference, Jeju, Korea
15 June 2008



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

Increase of default rate of subprime mortgages
Decrease in real estate prices in the US

Triggers

- Rating agencies
- Monolines
MTM losses
- Downgrades
Threats

Financial markets

- Stress on structured products
- Stress on conduits (SIV, ABCP)
- Stress on money market funds

VALUATION ↔ **LIQUIDITY**

Banks

- P & L channel
 - Losses
 - Write-downs
- Balance sheet channel : reintermediation
 - Return of off-balance sheet assets
 - Pipeline risk

PRESSURE ON BANKS' CAPITAL

Real economy

- Credit restriction
- Pressures on real estate
Negative wealth effects

 = Contagion channels

Source: Banque de France

De-leveraging and capital injections still needed

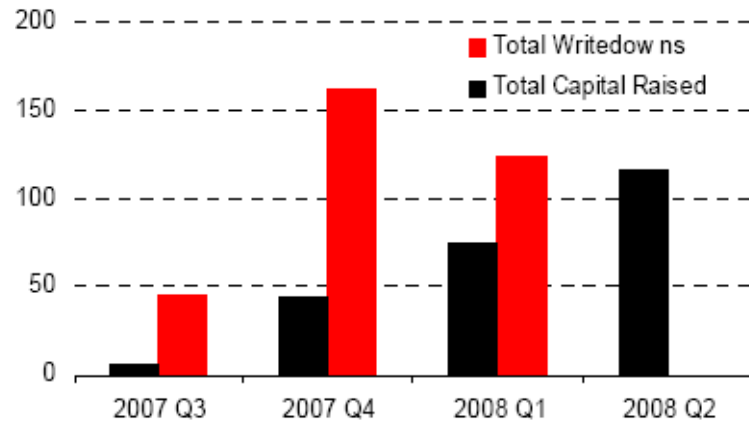


- Process is well under way but will be long and will have adverse economic consequences
 - Lower bank profitability, depressed stock prices
- Recapitalization needs higher in the US due to need to recreate bank loans portfolios to substitute for securitized credit?

Magnitude of de-leveraging and capital injections



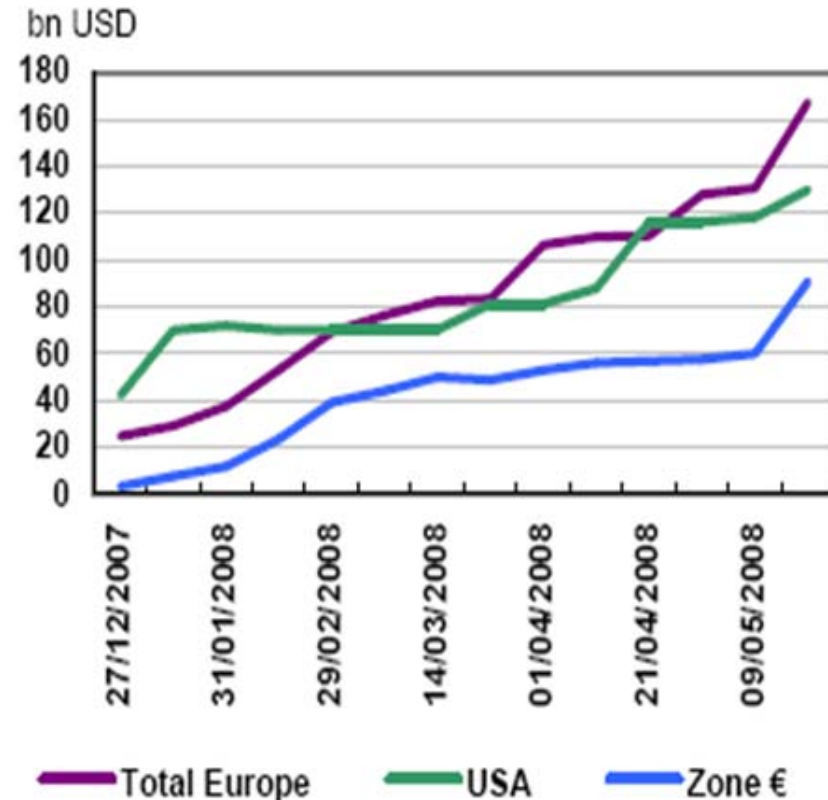
Write-downs and capital raising



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

Source: SG

Write-downs in the US and Europe

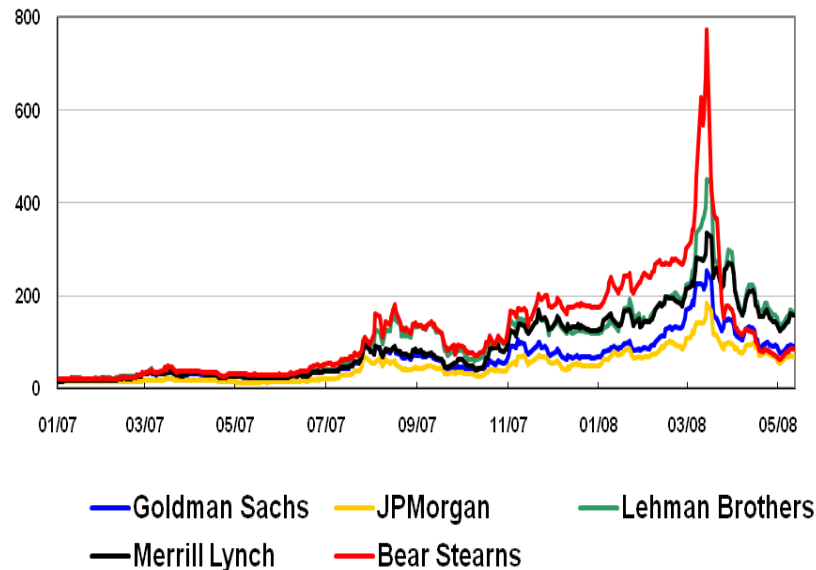


Light at the end of the tunnel?



Yes: Normalization under way

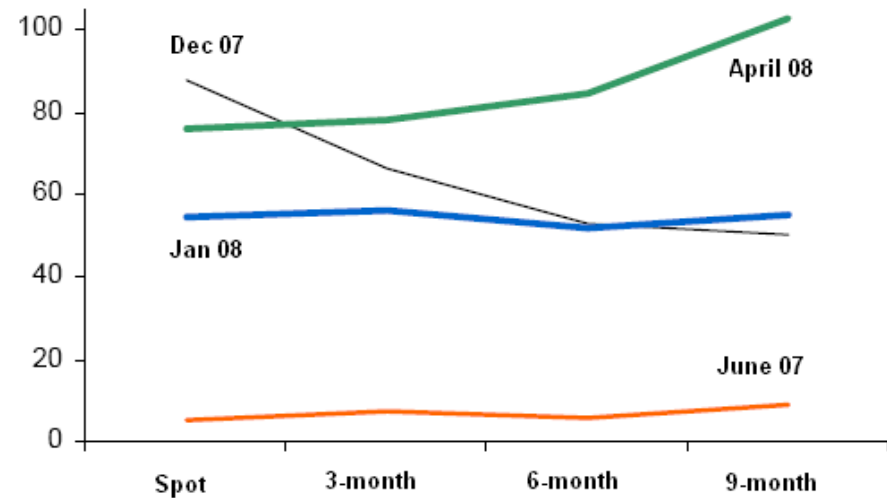
5-year CDS spreads



Source: Banque de France

No: Crisis still unfolding

Euro area Euribor-OIS spreads



Source: BNP Paribas

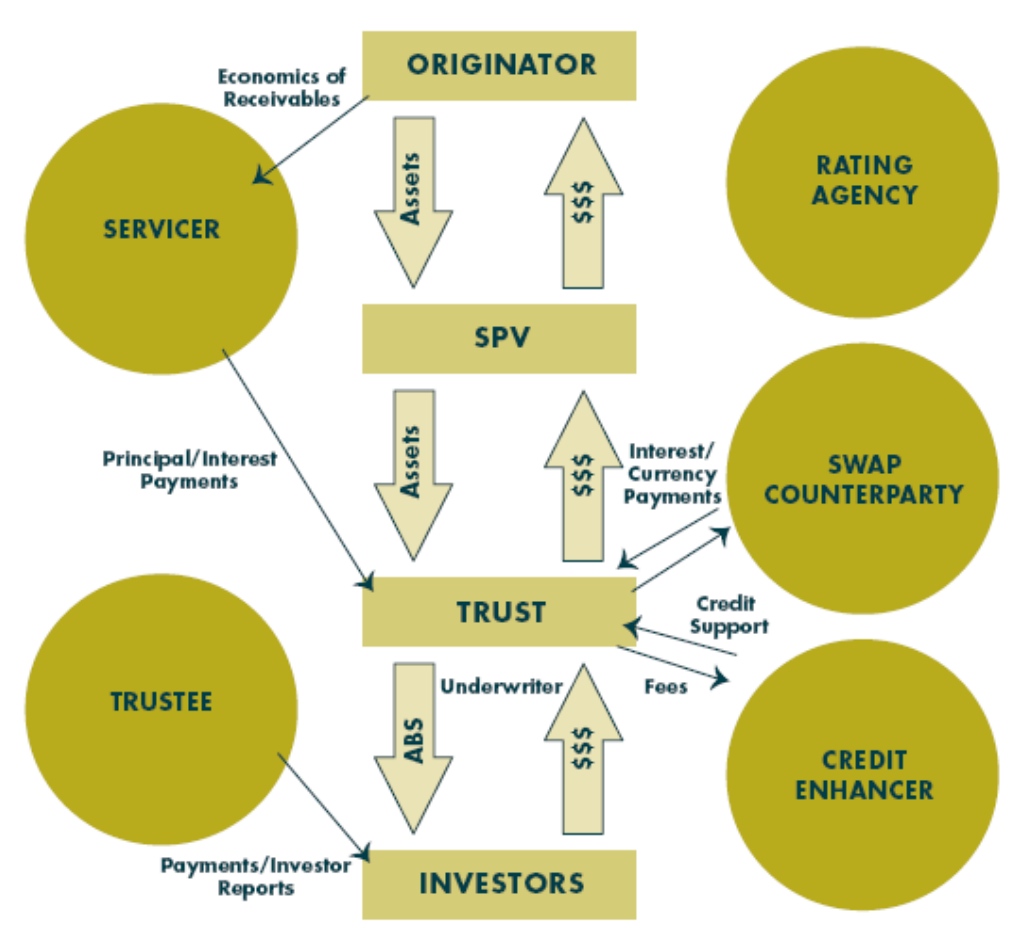
2. What have we learnt?

(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



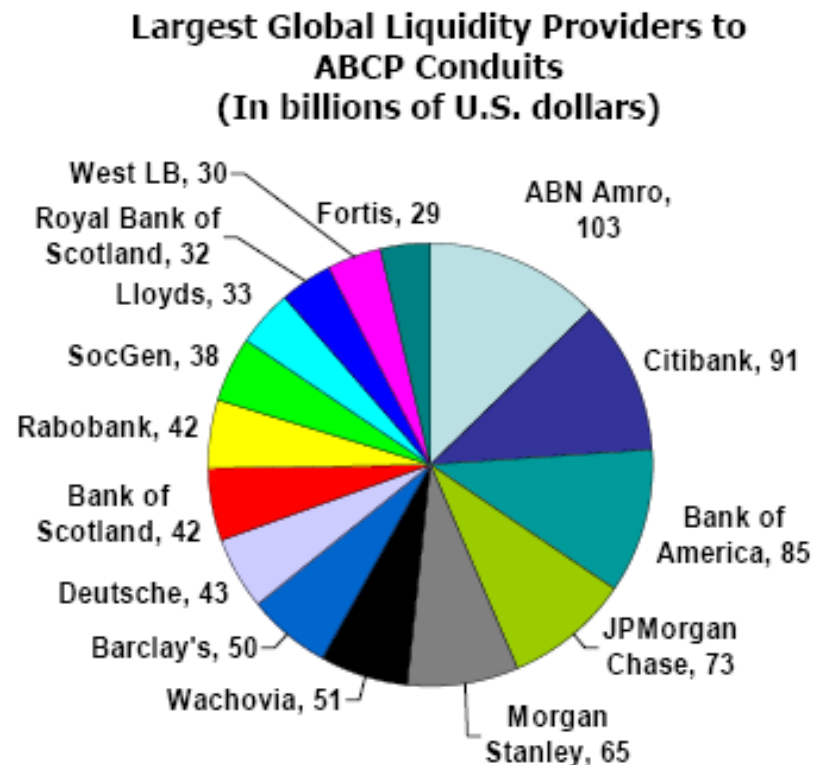
Source: *European Securitisation Forum*

(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 and 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.