



The Financial Crisis: The Policy Agenda

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Fig 1: The Crisis Causes/Symptoms

- Macro liquidity excess—the overfilling dam.
- Basel system and capital arbitrage—(cracks in the wall).
- Tax arbitrage & CDS—(cracks in the wall).
- Leverage rule changes for US investment banks: consolidated SEC supervision to lax European standards.
- Too big to fail (systemic size).
- Overlapping and captured regulators. (OTS for AIG!!!).
- Poor corporate governance/risk control.
- Not enough capital/losses/deleveraging & raising capital starts = recession.
- Massive support packages: liquidity, fiscal, loans, guarantees, bad banks—you name it they did it.

Fig. 2: Losses, Capital Rebuilding

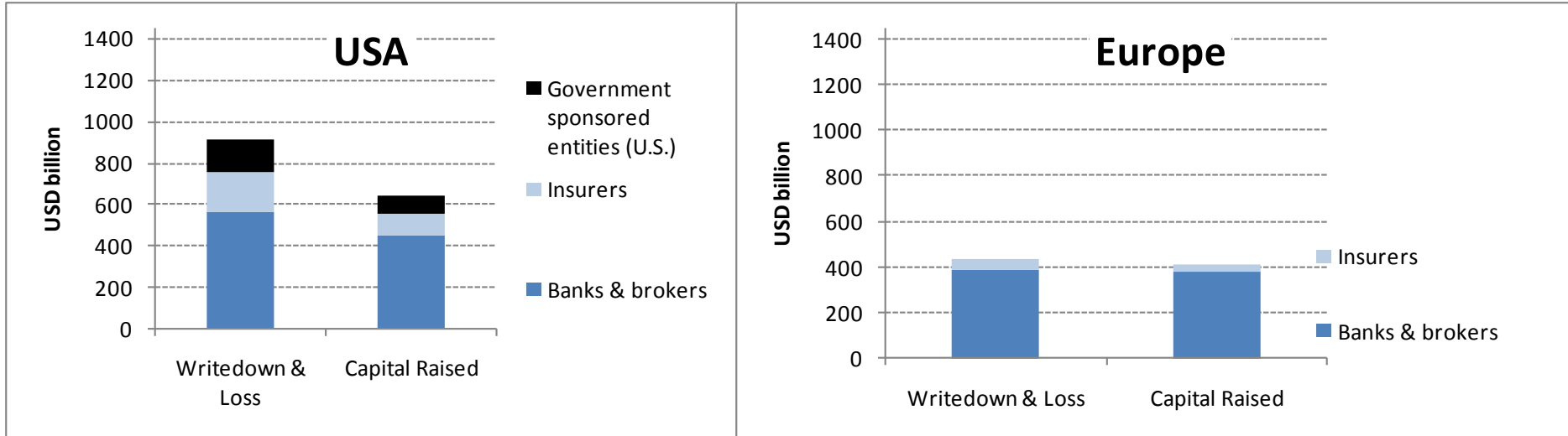


Fig. 3: Leverage Ratios Prior to the Crisis

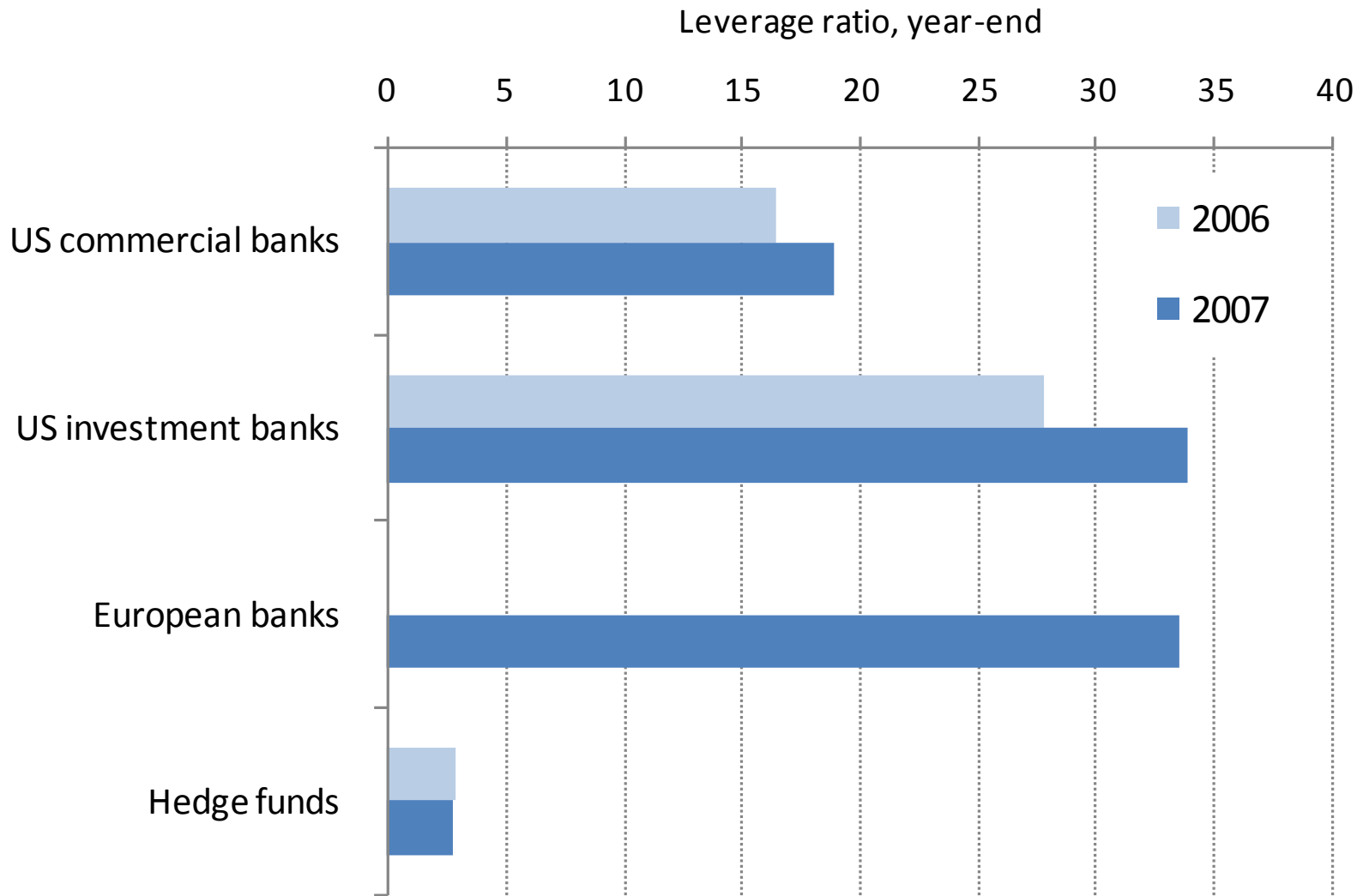


Fig. 4: USA (19 Banks) Losses, Capital Raised & SCAP Scenarios

(billions US dollars)	2007&2008	2009&2010 (Baseline)
Capital end 2008	608.0	
Assets end 2008	10892.5	
Leverage Ratio	17.9	
Balance Sheet Writedowns	563.6	
SCAP consistent baseline Loss F/cast		361.3
Capital Raised	444.3	0
Shortfall B/sheet	119.3	480.6
B/sheet cap needs (ex VIE's)		480.6
Off B/Sheet Exposures		
VIE's now consolidated onto B/Sheet (end 2008)	110.0	
VIE Outstanding (end 2008 unconsolidated)	796.3	
Unconsolidated VIE Loss exposure		389.4
Resid. Capital Needs end 2010 incl. VIE Loss Exp.		870.0
QSPE Outstanding end 2008	3192.4	
QSPE Loss est. (not a US bank Problem)		567.0
Losses banks are responsible for (SCAP+VIE)	563.6	870.0
Less earnings est.		434.0
IMF forecast for all US bank losses	563.6	1040.4

Memo underlying earnings per annum @ 2% on assets end 2008 \$218bn



Fig. 5: Europe (Loss Banks) Losses, Capital Raisings, & Scenarios

(billions US dollars)	2007&2008	2009&2010 (Baseline)
Capital end 2008	1076.9	
Assets end 2008	39645.7	
Leverage ratio	36.8	
Balance Sheet Write Downs	436.1	
Capital Raised	399.9	
IMF Loss Forecast		300.9
Shortfall B/sheet	36.2	337.1
Cap. Needs (Assumes Zero Off B/Sheet Exp.)		337.1
Capital to get to the lower US leverage ratio		
Assets allowing for 5% growth		43709.4
Capital Required for leverage ratio of 17.9 (USA)		2441.9
Tot. Req. Capital (Assumes no Off B/Sheet Exp.)		2779.0
Off Bal./Sheet Issuance + Share US QSPE's		
Tot. Eur. issuance of CSO's to 2009Q1 (book val.)	2141.9	
1/3 Share of US QSPE issuance??	1053.5	
Loss exposure that banks are responsible for		UNKNOWN

Memo earnings per annum @ 2% on assets end 2008 \$793bn

Fig. 9: Synthetic CDO's & CLO's

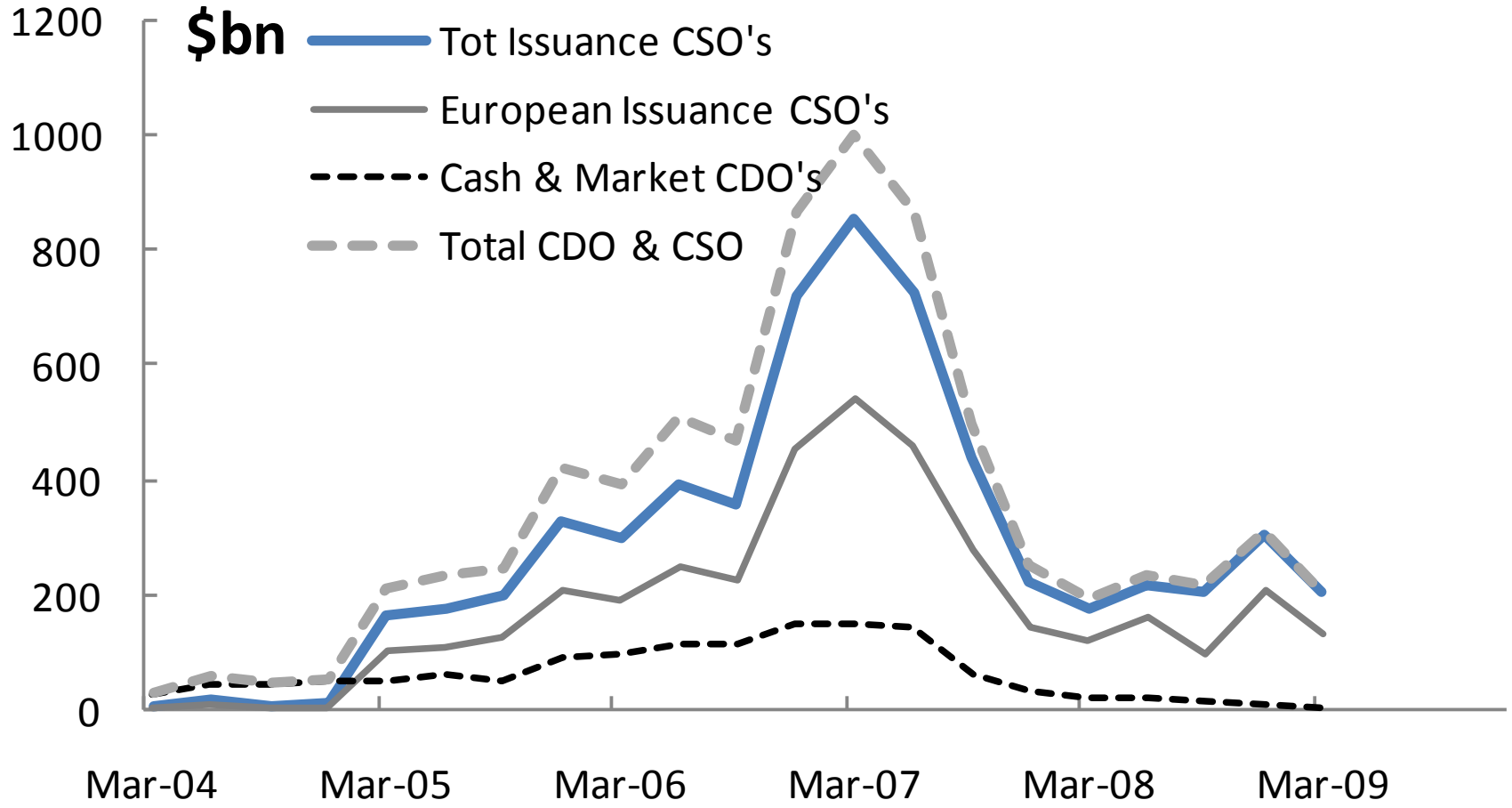


Fig 6: The Policy Agenda

- Deal with toxic assets
- Capital (& Tax) regulation: much better, not more. Policy Bungling caused this crisis.
- Equity culture and governance
- Competition versus contagion
- Pension reform

Fig 7: Bad Bank Approaches

- AM approach, (US PPIP): Advantages: quick; uses market skills in pricing & managing; shares taxpayer risks with private sector; open market approach=level playing field.
- Swiss approach: Government “bad bank” for UBS toxic assets; plus partial nationalisation. Disadvantages: taxpayers take all the risk, and no level playing field.
- UK Approach: ring fence the bad assets on the balance sheet, and guarantee them. Disadvantages: same as Swiss approach.
- Mergers: Bank of America takes Merrill’s, Lloyds takes HBOS, Wells takes Wachovia. AHEM!! 2 turkeys don’t make an eagle—no new net capital, and systemic size rises.

Fig 8: Capital Regulations

- Banks are desperately short of capital—Basel II asks them to hold less.
- Basel Pillar 1 does not penalise concentration risk!!!!
And relies on supervisors to do something in pillar 2!!
- Basel lets the regulated entities determine their own capital weights!!!
- Basel II does not allow for idiosyncratic or local risk (based on a single global risk factor).
- Weightings create regulatory arbitrage possibilities.
- **A SIMPLE LEVERAGE RATIO IS SUPERIOR: BASED ON TOTAL ASSETS ON AND OFF BALANCE SHEET.**

Fig 12: The Hypo Bank Quote

- By purchasing CDS protection on its assets, which remain on its balance sheet, Hypo transfers the credit risk to someone else, and this is recognised in its Basel risk-weighted assets. (As long contracts can be renewed—no global financial crisis).
- *“Since October 2007, DEPFA has been a member of the Hypo Real Estate Group, and this transaction achieves a number of objectives for DEPFA, and the Group as a whole: DEPFA has reduced the amount of regulatory capital required to support the assets (which under current BIS rules are 100% risk weighted, though under Basel II this will reduce substantially), and at the same time has improved the return on equity and credit risk”*

Fig 12: Northern Rock CEO & UK Treasury Committee Evidence

- Mr Fallon: *“Mr Applegarth, why was it decided a month after the first profit warning, as late as the end of July, to increase the dividend at the expense of the balance sheet?”*
- Mr Applegarth: *“Because we had just completed our Basel II two and a half year process and under that, and in consultation with the FSA, it meant that we had surplus capital and therefore that could be repatriated to shareholders through increasing the dividend.”*

Fig 13: The Tax Issue

- The tax system encourages securitisation.
- Tax haven opaqueness allows capital gains and income to be blurred in CDO creation
- Inequality of tax treatment of income and capital gains/losses causes CDS boom in synthetic CDO's.
- Debt versus equity bias pushes up leverage—double dipping deductions.

Fig. 15: The Explosion of CDS Contracts

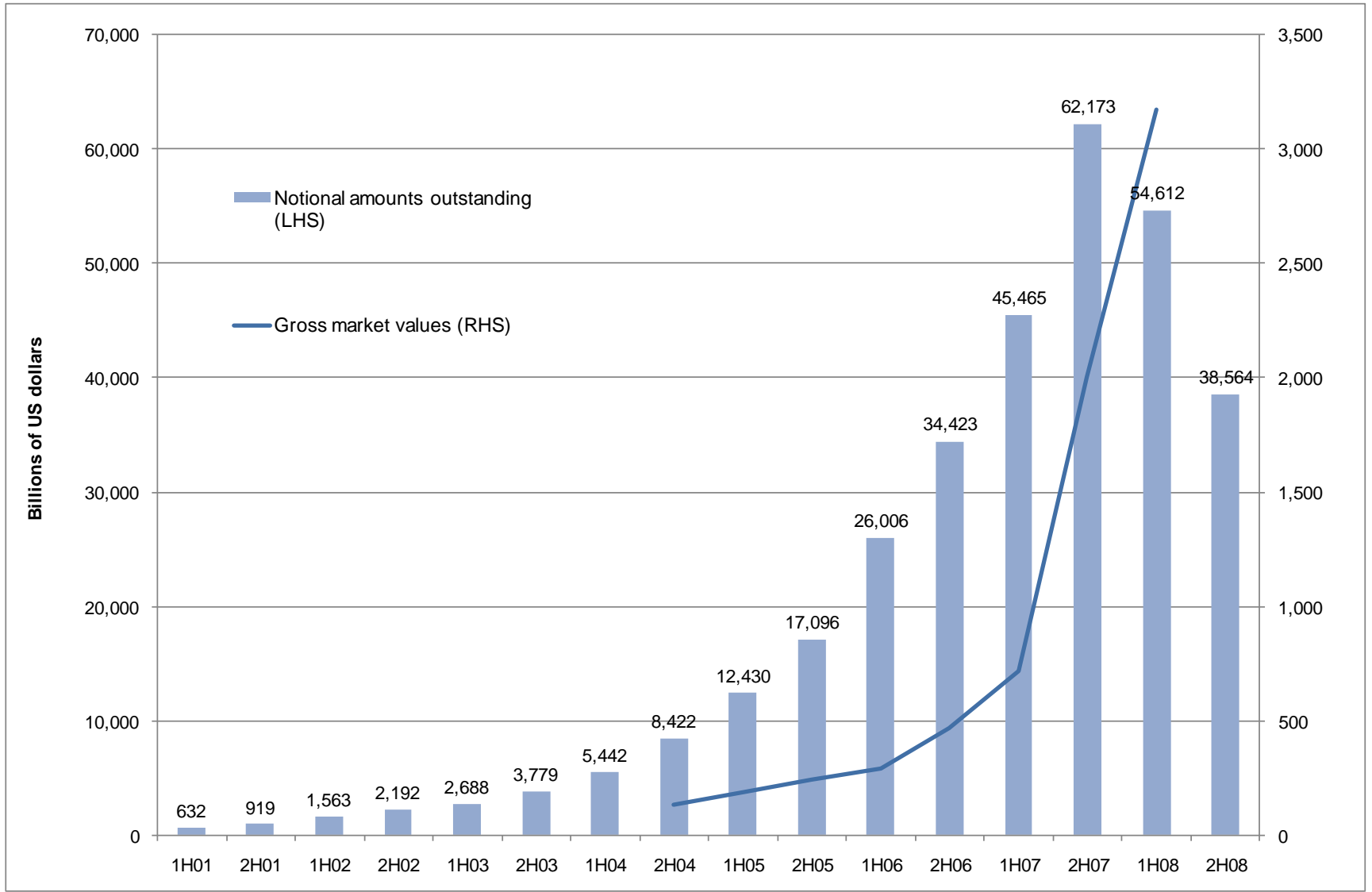


Fig. 16: \$70.6bn Payments to AIG Counterparties (\$45.7bn to EU!): Sept. 16 to 31 December 2008

Institution	(billions of US dollars)		Total	As a share of capital*** at end-2008
	Collateral postings for credit default swaps ¹	Payments to securities lending counterparties**		
Goldman Sachs	8.1	4.8	12.9	29.1%
Societe Generale	11.0	0.9	11.9	28.9%
Deutsche Bank	5.4	6.4	11.9	37.4%
Barclays	1.5	7.0	8.5	20.0%
Merrill Lynch	4.9	1.9	6.8	77.4%
Bank of America	0.7	4.5	5.2	9.1%
UBS	3.3	1.7	5.0	25.2%
BNP Paribas	...	4.9	4.9	8.3%
HSBC	0.2	3.3	3.5	5.3%
<i>[memo: Bank of America after its merger with Merrill Lynch]</i>			12.0	<i>[18.1%]</i>

*Direct payments from AIG through end-2008 plus payments by Maiden Lane III, a financing entity established by AIG and the New York Federal Reserve Bank to purchase underlying securities.

**September 18-December 12, 2008.

***Common equity net of goodwill; net of all intangible assets for Merrill Lynch and HSBC.

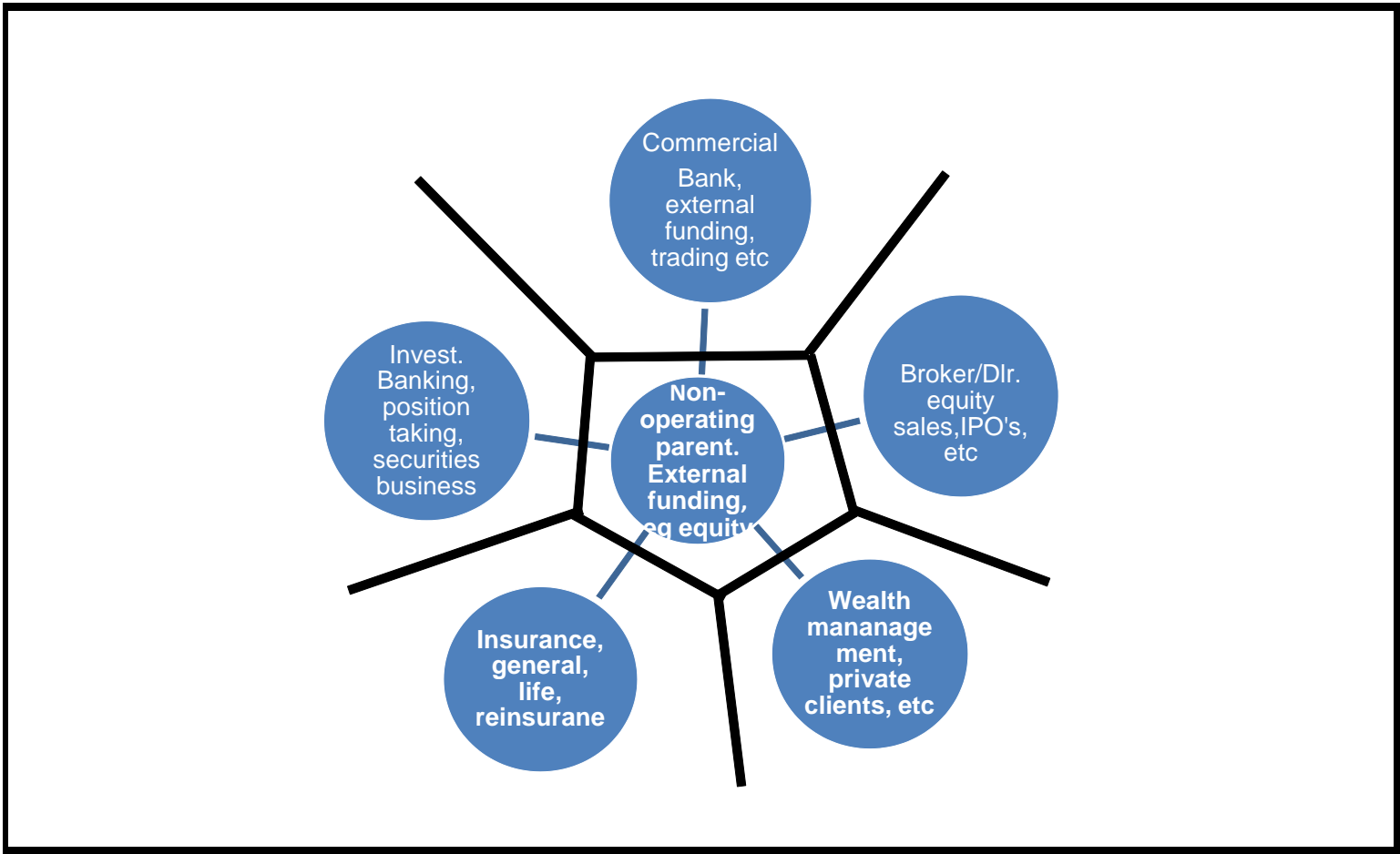
Fig 17: Equity Culture, & Competition vs Prudence

- Equity culture—fee driven earnings and the driving the share price, with benefit from bonus remuneration.
- “Too big to fail” is a huge problem—moral hazard in risk taking (bank lending/underwriting and by investors/depositors).
- “Too big to fail” problems come out of merger policy and what you allow banks to do—such as own investment banks and permit massive leverage on the balance sheet.
- Australian banks are in the top 10. Why? 4 pillars policy, they don’t do investment banking and they had profitable lending opportunities driving funding (not the other way round).
- You need profitable lending opportunities, not raise deposits and debt to search for fee-driven, regulatory and tax arbitrage to push up bank share prices.

Fig 18: Competition Policies

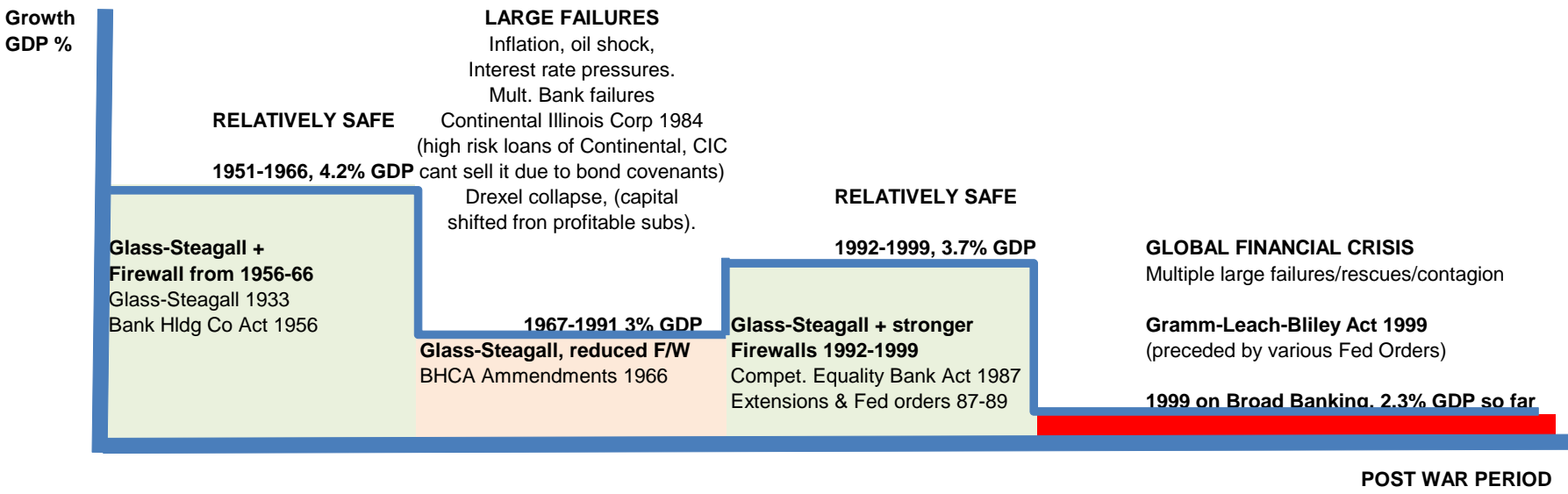
- Open market buying of toxic assets is least distortive;
- Foreign acquisition of domestic weak banks fosters better competition.
- Selling asset of failed firm in pieces enhance competition.
- Temporary nationalisation is better than a megamerger.
- Promote entry with competitive mergers of smaller healthy banks—e.g. regionals—in overbanked jurisdictions. They are ready to lend and competition will force recapitalised banks to lend.
- Foster removal of regulatory barriers to entry: fine grained credit rating information on consumers and small businesses; ‘switching packs to reduce customer inertia; remove regulatory barriers.
- NOHC structures to foster transparency, competition, and regulatory ease.

Fig. 19: Non-operating Holding Company NOHC



Source: , OECD

Fig. 19: Financial Innovation Is Crucial for Growth Myth



Source: , OECD

Fig 20: Corporate Governance

- Independent directors: strengthen fit and proper person test to cover competence, technical expertise. Risk management skills; formal separation of CEO and Chair; term limit on board membership.
- Risk officer role with access to the board (with special employment terms--CEO doesn't fire or set salary).
- Fiduciary responsibility of directors: clarified tying duties to single affiliate in the case of complex firms.
- Remuneration: board reform helps, and tax incentives provide teeth.

Fig 21: Pension reform

- No tapping public pension reserve funds.
- Strengthen confidence in private pension systems—no reversion to public dominance.
- Crisis forbearance over funding should be temporary.
- Strengthen pension fund governance—fit and proper persons with expertise.
- Consolidate small pension funds.
- Reconsider regulations that aggravate selling in the crisis—countercyclical funding rules.
- Hybrid pension arrangements to reduce risk as pressure mounts on DC schemes: promote DC with lifetime target returns and indexation features when solvency permits.
- More choice in accumulation and retirement stages: conversion rules for annuities; default asset allocations ; i.e. to ease timing risks and new pressures from the crisis (need to work longer etc).
- Strengthen financial education.