DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMMITTEE ON FINANCIAL MARKETS

LESSONS FROM THE FINANCIAL MARKET TURMOIL:
CHALLENGES AHEAD FOR THE FINANCIAL INDUSTRY AND POLICY MAKERS

OECD Financial Roundtable meeting
Discussion note

13 November 2008

The meeting will be held from 10 a.m.-1:00 p.m. on Thursday, 13 November 2008, and will take place at the OECD Headquarters in Paris, Château de la Muette, in Room CC1 of the Conference Centre, entrance at 2 rue André-Pascal, 75016 Paris. More information, including a list of hotels in the vicinity, can be found at www.oecd.org/conferencecentre.

For further information please contact Mr Gert Wehinger [Tel: +33 145 24 87 68; E-mail: gert.wehinger@oecd.org].

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Discussion note for the OECD Financial Roundtable
13 November 2008

A. Meeting background and overview

The Financial Roundtable
is a core component of the biannual meetings of the OECD Committee on Financial Markets

1. The OECD Committee on Financial Markets comprises officials from OECD central banks, finance ministries and other financial authorities, who meet biannually to review structural, institutional, regulatory, and market developments in financial services in OECD countries and emerging economies. As part of these meetings, there is a meeting with representatives of the financial services sector – the OECD Financial Roundtable. The Roundtable allows for an off-the-record discussion on a specific topic between Committee members and selected representatives of the financial services sector.

This Roundtable discussion will focus on the lessons from the financial market turmoil and challenges ahead for the financial industry and policy makers

2. This note provides a general overview to guide the discussion at the upcoming Roundtable, which will focus on the following issues:

   – Assessment by the financial industry of policy actions taken so far.
   – Evaluation of current proposals by the industry as well as policy makers for financial sector and regulatory reform.
   – Challenges ahead and elements of a comprehensive regulatory reform.

3. A more detailed background and discussion of selected issues can be found in the Background paper for the OECD Financial Roundtable [DAF/CMF(2008)16/ADD1].

Issues proposed for discussion

4. Issues proposed for discussion may be found in Box 1. The questions raised are believed to be germane to these topics but are not exhaustive, and participants are encouraged to raise other points they wish to bring to the attention of the Committee. Participants’ interventions should be informal and short (5-10 minutes for lead speakers). The meeting is intended to be an open exchange of views between members of the Committee and financial market participants. Committee Members may use the information gleaned from the discussion to inform subsequent debate or as background information for follow-up work or studies, but specific remarks by participants are not for attribution and participants are encouraged to speak openly. Participants may, should they wish, provide a limited amount of focused material to be circulated and made available at the meeting.
Box 1. Issues for discussion

Round 1: Assessment of policy actions taken so far

- What are the views of participants with respect to private sector and official responses to the crisis so far, in particular, the recent US and European bank rescue plans? Are there particular issues and problems with the implementation of these plans (size, focus, coverage, consistency, asset vs. equity purchase, stigmatisation, conditions, etc.)? How to best deal with (subprime related) ‘toxic assets’? How useful were short-selling restrictions? How to best ensure ‘orderly’ further deleveraging of financial institutions? What are the preconditions and prospects for re-capitalising financial institutions (with a view to more market-based solutions, including investments by sovereign wealth funds, hedge funds and private equity)?

Round 2: Evaluation of current proposals

- What is the participants’ assessment of the various reform proposals by regulators and the industry? How to enhance risk awareness and risk management (including liquidity risk)? How can changing the incentive structure help (compensation, fees)? What measures can be taken to ensure proper management of counterparty risk? Will CDS clearing houses be helpful in this respect? How to enhance transparency, in particular with respect to structured products, derivatives and off-balance sheet vehicles? How to address problems of valuation (pro-cyclicality)?

Round 3: Challenges ahead and elements of a comprehensive regulatory reform

- What are the key elements of a more comprehensive regulatory reform? How should co-operation and co-ordination between the private and official sector on this matter be enhanced? What should be the scope for cross border co-operation and harmonisation? Should authorities reel in the financial safety net? If so, how? Which entities should be excluded? How much financial activity should be allowed to take place outside the regulatory sphere? How to strengthen oversight of credit rating agencies? What about the future of the highly leveraged wholesale business model? How should investment banking be included in any new regulatory structure? Should capital requirements be more comprehensive (also taking into account balance sheet size)? Should there be quantitative limits to certain (very risky) exposures? Is there a need to develop additional early warning systems? What would they include and how can the industry contribute (reporting, data)? How can we ensure stability while not stifling financial innovation?

B. The crisis and major policy responses: Assessment of policy actions taken so far

1. A brief retrospective

   Turmoil of global dimensions is ending a period of narrow risk spreads and search for yield

   5. This turmoil is of global dimensions, and is ending a period of narrow risk spreads and search for yield that had been fuelled by abundant liquidity (see Figure 2 for a schematic overview). Increased risk-taking had been fostered by market pressures and was supported by the originate-to-distribute model. Favourable ratings and lack of due diligence on the part of investors added to the problem, but regulators and supervisors either lacked diligence or were too accommodating. Analysing the origins of the crisis can help suggest elements needed for future reforms.
Figure 2. Evolution of the current crisis

The triggering event
- Higher-than-expected defaults on US subprime mortgage loans

The propagation channel
- From real estate markets
- To asset-backed securities markets
- To bank balance sheets
- To inter-bank funding markets
- To the broader credit market

The broader impact
- Stock prices initially plunged;
- Investors reoriented portfolios toward low-risk assets and out of riskier classes
- Volatility rose markedly
- Market liquidity has been severely impaired
- Demand for liquid assets shot up

Implications for policy
- No two crises are exactly alike
- Policymakers must be flexible to respond according to the requirements of specific crisis events
- Authorities must first ensure stability of the system
- Other issues should be carefully considered before they are implemented

Source: OECD.

Origins of the crisis suggest elements needed for future reforms

6. Thus, while this crisis has displayed many of the traditional features that characterised other crises in the past (credit and asset price growth in particular), there are some idiosyncratic features of the current financial turmoil that policymakers and the industry need to address in their longer-term reform measures in response to the turmoil. These features are:

- the expansion of the originate-and-distribute model of transferring risk;
- a high appetite for yield that nurtured a growing demand for high-risk assets;
- ex-ante ignorance and ex-post uncertainty about the risk features of mortgage-backed securities, related derivatives and credit-default swaps;
- inadequate corporate governance and management incentives in financial institutions; and
- the role of regulators and rating agencies.
### Table 1. Main areas of policy measures by G7 countries and EU in response to the crisis

As of end-October 2008

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<thead>
<tr>
<th></th>
<th>United States</th>
<th>Japan</th>
<th>Germany</th>
<th>United Kingdom</th>
<th>France</th>
<th>Italy</th>
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<th>EU/EMU wide(^a)</th>
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<tr>
<td><strong>Monetary Policies</strong></td>
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<td><strong>Regulatory interventions</strong></td>
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<td>Political guarantee of all deposits</td>
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<td>General guarantees to banks</td>
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<td>Support for homeowners</td>
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<td>Rescue loans to non-financial sector</td>
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**Legend:**
- ● Policy being implemented.
- ○ Policy being planned or envisaged, or implicit in other policies.

**Notes:**

- a) European Monetary Union (EMU) wide for monetary policy measures by the ECB, European Union (EU) wide for other measures.
- b) Includes broadening of categories accepted as collateral, changing the terms and conditions of liquidity arrangements (e.g., longer maturity), increase in amount or frequency of actions, open market arrangements (e.g., overnight repurchase agreements, term repo, etc.), and swap arrangements with other central banks.
- c) Measures include regulatory reform measures, stricter enforcement, broadening authorities of supervisory agencies, increase in on-site inspections, enhanced stress testing and monitoring of liquidity, enhanced marked surveillance and scrutiny of risk management practices (with focus on institutions with perceived exposures to troubled sectors), increased data collection (e.g., on subprime exposures), and the like.

**Sources:** OECD, ECB, EC, and national sources.
2. Major policy responses to this crisis

Policy actions to deal with the crisis have often been ad-hoc

7. The financial industry as well as policy makers have been struggling with the fallout of the turmoil. Many actions have been taken so far, often ad-hoc, to deal with problems that have arisen along the way. Fiscal support to subprime lenders, central bank actions to enhance liquidity, bail outs of individual major financial institutions, and – dropping the case-by-case approach – the establishment of more general and co-ordinated government guarantees and capital injections for the financial industry (see Table 1).

Bank bail-out policies have become bolder as the crisis has evolved...

8. Recapitalising and bailing out banks have become the most important policy measures. Despite some state interventions to prevent bank failures over the past year or so (e.g. IKB in Germany, Northern Rock in the UK, and Bear Stearns in the US), there was still some hope that the market would provide the essential funds to recapitalise banks on a wider scale. However, after the US government had taken the weakened GSEs Freddie Mac and Fannie Mae under conservatorship, after the repercussions of Lehman’s failure and the rush of the government to support AIG it was becoming clear for many policy makers that a more structured approach to support the financial sector was needed.

...and, on both sides of the Atlantic, also more structured and co-ordinated

9. In the US, the Treasury proposed a ‘Troubled Assets Relief Program’ (TARP) which was enhanced by lawmakers to become the more encompassing ‘Emergency Economic Stabilization Act’ (EESA). In Europe, once the severity of the problems for the EU banking sector at large had been recognised, a co-ordinated action plan was agreed at the EU-wide level. Government support for the banking sector was also announced in other OECD economies. The man feature in all these plans is a substantial capital support by governments for the banking sector (or, to begin with, selected major institutions) either via asset purchases, equity participations, or guarantees.

3. Some lessons for policy makers

Deleveraging of a highly leveraged financial sector is necessary but difficult, and cannot be addressed by official lending

10. Not only the build-up of the crisis, but also the effects of and reactions to some of the initial policy responses have revealed some further shortcomings. While far from exhaustive, a short list of policy lessons to be drawn from these shortcomings is given in the following paragraphs to stimulate further discussion.

Liquidity injections are necessary but not sufficient in severe circumstances

11. First, a benign economic environment should not lead to complacency. Lenders often paid too little attention to a borrowers’ ability to repay, focusing too much on the expected (and expectedly rising) value of the collateral. This built up leverage and overcapacity in the financial system, accompanied by asset-liability mismatches. In conjunction with the pro-cyclical nature of asset-based lending, this is making deleveraging difficult. Official lending to ailing institutions could not address the leverage problem and did thus not go very far as the crisis of liquidity became one of insolvency.

12. Second, a lender of last resort (LOLR) is necessary to restore confidence, but is not sufficient if trust in the system overall is low. Liquidity injections need to be complemented by asset purchases and capital injections.
Policies need to be predictable and time consistent, in particular with respect to bail-outs...

13. Third, policies need to be predictable and time consistent. This is particularly important with respect to bail-out policies in order to avoid moral hazard. Investors’ wrong-guessing with respect to Lehman’s case underscore the need for explicitly established bailout rules. Specific problems may arise if institutions are not only ‘too big to fail’, but also ‘too big to save’, in which case co-ordinated international support is required. Furthermore, ‘stigmatisation’ in bail-outs should be avoided for stability reasons. Careful assessment has to be given to the design of the bail-out plan, whether the focus is on asset purchases (‘toxic assets’), equity participations or guarantees. Finally, governments as investors may also need to carefully consider (and perhaps take into account in the plan’s design) an exit strategy as banks’ shareholders.

…and also short-selling rules

14. Fourth, restrictions for short-selling that had been introduced on an ad-hoc basis in the United States and elsewhere should follow clear rules in order to avoid further market disruptions. An uptick-type rule would be helpful and time consistent. Many institutional investors, with the intention of safeguarding the value of their assets, have incentives to stop lending to short-sellers, and this could be viewed as market-based contribution to curb short-selling.

C. Selected reform proposals and areas of reform: Evaluation of current proposals

Various reform proposals have been made by the industry, official authorities and international standard-setting bodies...

15. Various reforms have been proposed by the financial industry as well as by official authorities and international standard-setting bodies. Many of these proposals arrive at similar conclusions regarding the causes of and remedies for the crisis. Among the most pertinent proposals by the industry in response to the crisis are those of the Institute of International Finance (IIF) and the Counterparty Risk Management Policy Group III. The major official responses are co-ordinated by the Financial Stability Forum (FSF), which also engages in dialogue with the private financial sector and other relevant stakeholders, and as such has taken into account many of the IIF’s proposals. Among the proposals put forth by major governments are the recommendations by the US President’s Working Group on Financial Markets (PWG) and the European Union’s Roadmap for strengthening financial stability. Of the international standard-setting bodies, the Basle Committee on Banking Supervision (BCBS), for example, has contributed with proposals to improve liquidity risk management and supervision.

…and show considerable agreement

16. In highlighting shortcomings that led to the crisis and areas of reform all these proposals show considerable agreement. In the following paragraphs some of these areas will be highlighted for further discussion, also with a view to soliciting responses by participants to point out differences between the various proposals and main areas of disagreement therein.

Risk culture and risk management

17. Shortcomings in risk management, which exacerbated the crisis, need to be addressed. Compensation schemes need to be made more compatible with risk over the time horizon of a project, and governance structures should incorporate risk managers at high level. Also, cooperation of risk managers is crucial in internationally active institutions. Furthermore, over-reliance on single models should be avoided and stress-
testing needs to be enhanced by also taking into account aggregate risk. The crisis also highlighted the need for giving more attention to *liquidity risk* in risk management and funding strategies.

### Counterparty risk and derivatives

18. *Counterparty risks* pose special challenges as they are complex and difficult to measure, and those from derivatives trading turned out to be most problematic. This underscores the need for improved settlement and trading procedures, and perhaps a tightening of margin requirements. CDS *clearing houses* which have been or are being established can be helpful in this respect, and will better allow tracking of risky OTC derivatives.

### Transparency in disclosure, valuation and ratings

19. Enhancing *transparency* by improving disclosure, valuation and ratings will help in restoring market confidence. *Standardisation* of structured securities will be helpful in this respect, and so will improved *disclosure* by financial firms, in particular, with regard to subprime exposures. Pro-cyclicality in *accounting rules* may exacerbate difficult market conditions, therefore some relaxation is being considered. However, as these accounting rules foster transparency, the ‘fair value’ principle should not be abandoned. Improved *rating* procedures and reporting as currently proposed by rating agencies and authorities will also contribute to improve transparency.

### D. Challenges ahead and elements of a comprehensive regulatory reform: Selected issues

#### General considerations for reform include striking a balance between stability and growth

20. Further-reaching reforms are needed to restore confidence. ‘Good’ regulation has to strike a *balance* between stability and growth, and may need to embrace competition and innovation more carefully as has been done in the past. New regulation also has to take into account regulatory *arbitrage* – which, however, can never be fully avoided. The efficiency and effectiveness of new rules should be properly assessed.

#### Banking regulation needs to review capital requirements, re-define the scope of regulation, and perhaps enhance deposit and other insurance

21. Concerning *banking regulation*, cross-border rules are required for banking and finance, which has become increasingly global. Capital requirements may need to be reviewed and perhaps tightened in the medium and longer term. Bank-like activities should be included in regulation, and investment banking should perhaps be separated from counterparty and other activities. Deposit and deposit-type insurance mechanisms may need to be fostered, perhaps including insurance schemes for the money market mutual fund industry.

#### Financial crisis mechanisms need to be strengthened, including insolvency procedures, international co-operation and global surveillance

22. *Financial crisis procedures* are needed, in particular, procedures for unwinding large insolvent institutions. International *co-operation* is essential in crises, and lessons can perhaps be drawn from structures set up for the financial management of large-scale catastrophes. Multilateral *global surveillance* shall be reinforced to better prevent crises. A general reform of global institutions and the global financial architecture may be essential in order to achieve a more stable, resilient, sound and efficient financial system.