SUMMARY RECORD OF THE TOUR D’HORIZON ON FINANCIAL MARKETS

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Short-term funding markets

The Tour d’Horizon began with presentations from representatives from the three major central banks in the OECD, beginning with the Federal Reserve Board of the United States, followed by the Bank of Japan and then the European Central Bank. They described the conditions in their respective money markets, each of which was generally characterised by heightened stress, although much less so in Japan. The more benign situation in the latter country reflects in part the fact that Japanese banks have been less reliant on borrowing in international wholesale funding markets.

Short-term funding conditions in the United States, as measured by the spreads of LIBOR over overnight index swaps (i.e. instruments that allow financial institutions to swap the interest rates they are paying without having to refinance or change the terms of the loans they have taken from other financial institutions) have improved considerably since mid-October, when spreads rose to more than 300 basis points, but spreads remain elevated by historical standards. Also, volumes are low.

Funding pressures also remain at elevated levels in the euro zone. Up until mid-September, monetary policy operations such as frontloading and lengthening of maturities had succeeded in bringing the interbank market rate in closer alignment with the target rate, but liquidity in the interbank market came under severe stress in the wake of the collapse of Lehman Brothers.

Central bank operations

Against the backdrop of a reassessment of the inflationary outlook, the ECB took several additional policy actions: The ECB joined the concerted action taken by other central banks. Other measures included a narrowing of the width of its standing facility corridor (defined by the spread between the lending and deposit facility) from 200 to 100 basis points, and measures to further expand the list of eligible collateral and to enhance the provision of liquidity in US dollars. As a result, the ECB took over an important role in financial intermediation and its balance sheet expanded from one trillion to one and a half trillion Euro from September 2008 to end-of-October 2008.

The Bank of Japan openly expressed support for the actions taken by other central banks but did not adopt any specific changes in its own operating strategy. By contrast, the United States Federal Reserve has adopted a wide range of measures to address the fallout from the crisis. They include lowering its target for the federal funds rate, expansion in the types of collateral accepted for lending programs, lengthening of the maturities of agreements, and the introduction of new facilities to support among others, investment banks, money market mutual funds, and the asset-backed commercial paper market.

Structural backdrop to current crisis

According to the Secretariat, financial liberalisation and regulatory change, globalisation, and innovation led to a shift in the focus of banks towards expansion in fee income and share price growth and away from the traditional on-balance sheet deposit taking and lending-at-a-spread model. Compensation packages of executives came to depend more on growth performance and the share price (shares/options).
In the US, commercial banks sought to compete with investment banks, which were less regulated, and the way for doing so was helped by the removal of Glass Steagall Act, which had separated commercial from investment banking activities. Banks came to concentrate on earnings activities that did not attract regulatory capital charges and regulatory change actually facilitated this trend towards greater risk taking. In this context, it has been argued that banks began to shift their activities toward those receiving favorable treatment under Basel II, with its reduced weights for mortgages compared to several other types of securities. This treatment encouraged portfolio concentration in such assets and allowed banks greater scope to operate with less capital. At the same time, the Office of Federal Housing Enterprise Oversight (OFHEO) adopted quantitative and capital requirement changes that allowed banks greater scope to engage in mortgage securitization; and the surge in bank activity in this area was not matched by corrective action by bank regulators. While there was not much direct criticism of these hypotheses, some of the statements by delegates seem to suggest that the criticism leveled against Basel was not universally shared. For example, one delegate suggested that Basel II first needs to be implemented globally before one could talk about refining it.

**Dealing with toxic assets**

Another issue that drew attention was how to separate banks from their bad assets. The difficulties in this regard were linked to the changes that had occurred already in the US TARP program and hints of a TARP 3. The delegate from the United States explained that one of the difficulties facing attempts to buy toxic assets from banks was the great heterogeneity in the structure and quality of mortgage assets, which makes it difficult in practice to determine adequate prices under the preferred auction process. The delegate also pondered whether the US Treasury should necessarily be risk neutral in carrying out its purchases, suggesting that the answer was not obvious. The Secretariat suggested that, perhaps, banks did not want to sell because they are convinced that assets are worth considerably more than current market prices would suggest, so that they prefer to hold them until maturity. In response, the delegate from the United States said that structured products are also not homogeneous and that it is not universally true that market prices are too low; some structures are of quite poor quality. As well, small differences in the correlation between different risks can make for large differences in prices. The delegate from the World Bank concurred. Also, it is not so clear how much faith one could put in default rate models. Everyone now realizes that house price developments are crucial for default rates, but no one bothered to construct such models before the crisis. The Swiss delegate remarked that the purchasing of nonperforming assets was easier in Switzerland because the problem was limited to one, albeit big, bank, which facilitated the pricing of securities and made the issue of introducing competitive distortions through mis-pricing less relevant. The delegate from Japan noted that in the case of the country’s own banking crisis, it eventually turned out that some of the capital injected was indeed recuperated after the crisis had abated.

**Specific issues arising in banking sectors dominated by foreign institutions**

A number of delegates with banking sectors that are significantly influenced by subsidiaries of foreign banks drew attention to the linkages between the problems experienced at the headquarters of these banks and the credit conditions of the subsidiaries that operate in local markets. Group-wide considerations and the lack of proper functioning of foreign exchange swap markets have implied that there were negative spill-over effects from the headquarters to the periphery, even though there was hardly any direct exposure to toxic assets by the subsidiaries themselves. Despite this situation, the various subsidiaries of different international large financial institutions do not lend to each other.

**Targeting specific capital levels during the current crisis**

Some delegates raised the issue that, efforts to require banks to return too quickly to higher capital levels, may force banks to further cut back their financial intermediation activities, thus tending to make
growth deceleration even more pronounced. The targets in Basel 1 were essentially plucked out of a hat. No magic capital number drops out of an equation. The purpose of capital is to absorb losses, but what losses and over what timeframe are important questions.

**Too big to fail?**

There was some disagreement among participants regarding the interpretation of the notion of “too-big-to-fail”. A delegate noted that in the current situation some banks are simply too big to fail and that, under the current circumstances, policymakers should not even suggest that there should be failures. The Secretariat noted that the whole point of breaking up banks is to make the parts small enough that they can be allowed to fail. The Delegation from Japan noted, although not directly referring to the notion of “too-big-to-fail” that “to kill off zombie banks” is easier said than done, not least -- as pointed out by other delegates – because there is a risk of re-enforcing downward pressures.

**Existing guarantees were expanded and new ones introduced**

There was general agreement that the main policy response to the crisis consisted of the government provision of a financial safety net for financial institutions. In the process, existing guarantees have been expanded and new ones introduced. For example, where explicit deposit insurance schemes had not existed, depositor protection was raised through the introduction of such schemes. Australia, which had established an early access facility in June 2008, extended in October 2008 a three-year guarantee on all deposits in the country’s banks, building societies and credit unions. At the same time, the finance minister of New Zealand announced that the government has introduced an opt-in deposit guarantee scheme.

**Maximum deposit insurance coverage levels were raised**

The ceilings for deposit insurance coverage have been raised in many jurisdictions, with some statements suggesting either explicitly or implicitly even unlimited coverage. In this context, one interesting observation is that countries that did not make any changes since the last meeting and previously had comparatively generous arrangements compared to other CMF members (as shown in the charts in the background notes) are now clustered with other countries more or less in the center of the distribution. At the Spring meeting, CMF delegates agreed with the view that “a consensus seems to be emerging that one of the lessons from the run on mortgage lender Northern Rock in the United Kingdom is that deposit insurance systems with low levels of coverage and partial insurance, together with likely delays in repayment, may not be effective in preventing bank runs.” The policy actions taken in the fall 2008, in a way, could be seen as reflecting this understanding.

**Scope for tighter co-ordination exists in that respect**

One important observation is that the policy actions taken overall did not always appear to be closely co-ordinated across borders. Even though there was a widely shared sense that there was a strong need for communication and coordination of emergency policy actions, the actual implementation of measures, their timing, and sometimes also the statements accompanying the announcements themselves suggest that coordination was not as close as one might have hoped. Delegates agreed with the notion that there is scope for tighter co-ordination among authorities across borders. In the context of the EU, the Chair noted that deposit insurance directives are an issue for all EFTA and not just EU countries. Funding is an issue that is left somewhat unclear in the regulation and an issue that needs to be addressed in future work.

**Competitive distortions raised by guarantees?**

Some policy statements announcing increases in coverage levels have made explicit references to the actions taken in other countries. For example, in the case of some of the announcements introducing
blanket guarantees, such actions were justified as efforts to respond to competitive disadvantages arising from the introduction of similar guarantees elsewhere. In this context, there is indeed a perception that the provision of guarantees might provide some financial institutions or sectors with unfair competitive advantages as compared to their peers that operate in the same market but enjoy more limited deposit insurance guarantees. The unfair advantage could be vis-à-vis other forms of savings (e.g. close substitutes to bank deposits) or vis-à-vis other deposit-taking institutions that do not enjoy the guarantee in the same country or elsewhere.

**Difficulties in addressing moral hazard**

Like any guarantee, deposit insurance coverage gives rise to moral hazard. Deposit insurance can give rise to moral hazard both on the part of depositors, which may reduce their monitoring and “policing” efforts, as well as on the part of banks, which may anticipate the lessening of the threat of market discipline. Market discipline should be allowed to operate, however, as it can help reduce the final costs of settling a banking crisis. To allow for a greater role for market discipline and limit moral hazard it is important to specify when the extra deposit insurance will end (as some governments have done), and this timeline needs to be credible. The delegation from Korea described the experience of the country with the phasing out of a blanket guarantee, which was comparatively more rapid than in Japan. The Japanese delegation noted that Japanese banks may have been in a better position than US and European banks today and that injection of significant amounts of capital by the government was not feasible as there was little public support for such actions. More fundamentally, the US delegation agreed with the notion in the background paper that it is difficult to conceive of guarantees as a one-off proposition. Once extended it is questionable whether a guarantee can ever be fully withdrawn and not re-introduced during a subsequent crisis. The chairman concluded by saying that future work needs to address the issue of exit strategies.