ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

FURTHER INFORMATION RELATED TO THE PRESS RELEASE ‘THE OECD COMMITTEE ON FINANCIAL MARKETS CALLS FOR FUNDAMENTAL REFORM OF FINANCIAL MARKETS’ (15 APRIL 2008)

1. OECD PAPER: The Subprime Crisis: Size, Deleveraging and Some Policy Options
(please find underneath a summary of the paper – full paper available at www.oecd.org/daf/fin)

contact: Adrian Blundell-Wignall, Deputy Director, OECD (email: adrian.blundell-wignall@oecd.org)

- The latest OECD paper on the subprime crisis follows up the study last autumn that was the first in the official world to estimate losses in excess of $300bn. This time the OECD rejects the idea that the losses can be estimated (as before) using housing derivative prices, because they have been so distorted by illiquidity and fear in 2008. Such loss estimates depend too much on the vagaries of daily market prices, and can change by $100bn, month-to-month, even though there has been no shift in underlying defaults. Instead, this time the OECD estimates a default model independent of market prices, and calibrates an estimate for 'first round losses' based on an economic and house price cycle referenced against previous crisis periods in the 1990s and early 2000s. In this type of approach it is also important to allow for recovery on defaulted properties from the sale of collateral. Here the OECD takes a range of 40-50%--so if a subprime mortgage of $100,000 defaults, then only $40,000 to $50,000 will be recovered by the holders of the securities based on that mortgage. According to the OECD, if the slowdown in the US is like the modest recession of the early 2000s and house prices are worse than the early 1990s, then with a 40-50% recovery range, the mortgage related losses would come in within the (corresponding) $350-$420 billion range. This is significantly lower than the more alarming numbers provided these days, often based on the market prices approach, with its risk of distortion.
- The other interesting feature of the OECD study is its look at the banks in the US, whose share of the losses could be around $90billion. Left to resolve itself, this could lead to significant deleveraging—this is the technical term economists use for the more colloquial "credit crunch" idea. Banks need to raise capital to expand their balance sheets in normal times, meeting all the regulatory capital requirements. In a crisis this is hard to do, and if they are starting from way behind because they have $90billion of losses to deal with, well it is even harder. They have to find the $90billion in ultimate losses (not to be confused with write downs based of market prices etc) as well as raise more than that if they are to support a growing economy. The OECD points out that there are 3 ways to raise capital: via retained earnings; via capital injections from groups like Sovereign Wealth Funds and Hedge Funds; and via public money and the socialisation of losses. With regard to earnings, the OECD points out how Fed rate cutting helps bank profits, and speeds up the process—they also stress the need to cut dividends. But depending on assumptions about the Fed and dividends, it could take 6 to 12 months to recapitalise via earnings alone. This, the OECD judges, is too long. This raises the prospect of capital injections, including the case for public money. Here the OECD provides and interesting example of what could be done with a Resolution-Trust-Style approach to taking assets and liabilities off bank balance sheets.
- But the OECD also raises some longer-run concerns about the management of this crisis, including recent Fed action with Bear Stearns, and certainly any further use of public money. The OECD asks whether the effectiveness of markets as an efficient allocator of capital-scarce-resources can be relied upon for the future, when the trade-off between returns to risk is now asymmetric and banks know they are too big to fail. The OECD concludes "Fundamental reform of the financial system and its regulation has to be a key focus of the policy debate going forward. It will no longer be possible to assert the Panglossian view that we have the best of all possible financial systems."

2. OECD PAPER:: Financial guarantee insurance
(please find underneath a summary of the note prepared for discussion at the CMF meeting)

Contact: Sebastian Schich, Principal Administrator, OECD (email: sebastian.schich@oecd.org)

- There are a number of potential amplifiers of downward pressures. They include financial guarantee insurance companies (or 'financial guarantors' or 'bond insurers'), which are monoline insurers that essentially lend their credit rating – typically traditionally triple-A -- for a fee. Some of these companies have moved from their traditional business of insuring municipal bonds to guaranteeing payment of interest and principal in structured financial products.

- Despite the growing role of financial guarantee insurance in the securitisation process (that has come to characterise modern financial markets), however, the entities providing this specific financial service received relatively limited attention until early 2008, when several rating agencies openly discussed the possibility of taking adverse rating actions related to the biggest entities in that sector. Perceptions of the risk implied by financial market indicators, in particular the level of credit default swap premia, were at times clearly out of line with the triple-A rating awarded to these companies by credit rating agencies.

- The credit rating downgrade of a big financial guarantor is key to its business model, which is to lend its rating to a debtor against a fee. A demotion of a financial guarantor would not only severely affect its own business outlook, but should also lead to downgrades of a significant part of the estimated USD 2400 billion of bonds that such companies guarantee. Such effects, in turn, could imply losses for systemically important commercial and investment banks that would be in addition to the estimated more than USD 400 billion. According to some estimates such additional losses could amount to several tens of USD billions. Thus, the adverse knock-on effect from downgrades of these entities on systemically important institutions could be significant.

- In this context, it cannot be excluded that rating agencies had forestalled quick actions as a result of their concerns about the broader adverse effects of downgrades. Indeed, any change in the status quo, in particular, any downgrades of financial guarantors would cast doubt on the validity of the originate-and-distribute model that has come to characterise modern financial markets and has benefitted many players, including the rating agencies themselves and others that receive fees based on the issuance of structured products. While these considerations may have been balanced by the fact that rating agencies increasingly rely on models to determine their ratings, the question whether incentive problems might exist remains a valid one, given current payment arrangements for credit ratings. This issue has to be seen against the background of a wider discussion regarding the role and performance of rating agencies in the originate-and-distribute model that has come to characterise modern financial markets, as well as the heightened role assigned to credit rating agencies as part of the new approach to banks' capital adequacy.

3. OECD PAPER: Deposit insurance

(please find underneath a summary of the note prepared for discussion at the CMF meeting)

Contact: Sebastian Schich, Principal Administrator, OECD (email: sebastian.schich@oecd.org)

- It is when a crisis hits that aspects of the financial safety net receive heightened attention. Financial safety nets include a lender of last resort, deposit insurance, and prudential regulatory policies and supervision. One specific element that has been in the spotlight since last fall is deposit insurance. The current financial turmoil provides regulatory and financial policy authorities with a timely opportunity to review existing financial safety net structures underlying the operation of financial markets, including the actual or potential role of explicit deposit insurance systems. Some countries are currently reviewing their existing arrangements, while others that do not have explicit deposit insurance systems are currently considering the implementation of such schemes. There are a number as preliminary lessons that are emerging from the effects of the turmoil and the adequacy of aspects of the design of deposit insurance systems.

- One of them relates to the extent to coverage: deposit insurance systems with low levels of coverage and/or partial insurance may not be effective in preventing bank runs. Repaying depositors in a failed deposit-taking institution in a timely fashion is crucial as well. Indeed, the combination of likely delays in repayment and, perhaps more importantly, low levels of full coverage and/or the specification of partial insurance (or co-insurance) are now widely thought to have contributed to the scale of the run on Northern Rock in the United Kingdom, where prior to this event only the first 2.000 GBP were fully covered per depositor.

- Noticeable differences exist regarding the coverage limits in constituencies of CMF participants. In several countries maximum deposit insurance coverage is similar to the equivalent of 30.000 thousand USD, while it can be somewhat lower in some countries and much higher in others. Even among European countries, considerable variation in maximum coverage continues to exist.

- There is no generally agreed optimal level of maximum deposit insurance coverage. While low levels of deposit insurance coverage may not be effective in preventing a run, high levels of coverage may be ineffective in reducing moral hazard. Thus, this observation raises the question what the considerations are regarding the trade-offs involved in specifying maximum levels of coverage.

4. Summary of the OECD Financial Roundtable: The recent financial market turmoil, contagion risks and policy responses: how well are we weathering the storm?

Contact: Gert Wehinger, Administrator, OECD (Email: gert.wehinger@oecd.org)

As is customary, the Committee on Financial Markets held its special session with representatives of the financial services sector, the "Financial Roundtable", prior to its plenary session, helping to provide inputs for the ensuing discussions at the official meeting. The private sector participants comprised representatives of major financial institutions, ratings agencies, monoline insurers, the hedge fund industry and a money market association. Three rounds of the discussion focused on the following issues:

1. Financial market outlook and impact of the crisis
2. How is the financial sector coping with the crisis
3. What lessons for policy makers and market participants can be drawn from the crisis?

1. *Financial market outlook and impact of the crisis*

- The US subprime mortgage crisis has now triggered wider repercussions on financial markets and institutions. Financial markets have dropped globally. The financial crisis weighs on the economies, and the likelihood of a US recession has increased, while other economies may not easily remain decoupled – Asian and Latin American economies being likely exceptions. It was noted there are significant differences within Europe: Housing market problems in Spain and Ireland, a strong German Economy, and risks in Eastern Europe and other countries which have a high share of foreign currency loans, and such differences are starting to show up in sovereign risk spreads. While the level of pessimism differed between participants, the time of recovery was estimated at about 12-18 months. Investors are looking for safe havens, indicating that the worst may not be over yet. But it is not easy to find safe havens now, risk appetite is low and "cash is king". The boom in commodity prices is caused by demand and supply effects, is highly correlated

2. *How is the financial sector coping with the crisis*

- Participants agreed that this was not mainly a crisis of credit, but one of fear ("greed turned into fear"). While central banks' actions have smoothed markets to a certain extent, a major task to restore investor confidence and overcome the crisis will be the recapitalisation of banks. Leverage in the system is still high, and while deleveraging has started, there is still and enormous overhang of "unwanted", mortgage-related assets. Cash-rich pension funds and insurance companies, which would have the potential to "bail out" the banks, have been forced by regulators into safe investments and will not be able to step in at this time. Some opportunities to strengthen financial institutions' balance sheets could lie in financial sector consolidation, but recent withdrawals of major planned acquisitions within the financial sector may raise doubts on such a solution in the near term, as long as it is impeded by fear. But it was also noted that hedge funds (which were at the forefront during a previous round of acquisitions and bail-outs), could again play a stronger role, as some see that many write-downs have now gone too far. Market sources for refunding damaged balance sheets may hardly be sufficient.
- Specific concerns about monoline insurers have added to the financial crisis. They have played a crucial role in the mortgage risk transfer process and have been warily watched by investors as their downgrading can have wider systemic effects. While they are the most leveraged with respect to structured finance risk (45 times, according to one participant), it was seen that the sectors as a whole is sound enough to weather the storm, and only the weakest institutions have been or will be affected. The crisis has been a "wake-up call" for the industry, and the fact that capital has been raised effectively underlines investors trust in the soundness of the industry.
- The "originate-to-distribute" model and risk transfer through mortgage securitisation is being put into question. As investors have now become more risk-averse and better evaluate and discern risk, alternatives to mortgage securities may become more important. Simplification of products ("dummying down" of securitisation) is taking place, and risks will be more closely linked to the originator.

3. *What lessons for policy makers and market participants can be drawn from the crisis?*

- Various proposals have been put forward by policymakers to deal with the crisis and to prevent future crises of this kind. These include mortgage market reforms, reforms concerning the Basle II accord, and a review of the role of rating agencies. Policy actions have to be geared towards enhancing transparency of complex financial instruments, of institutions and vehicles in order to restore market confidence in the long run. Also, while mark-to-market valuation was seen as very valuable, exceptions – when markets are thin or non-existent, or for certain buy-and-hold investments --- may need to be considered.

- This crisis has also made a strong case for <u>co-ordination</u> between market participants, but also between the private financial sectors and policy makers, in particular regulators and supervisors in order to help ensure efficiency in regulation.
- While it was agreed that policy actions have been helpful so far, some warned of overregulation going forward. Also, many <u>private initiatives</u> (e.g. by the IIF, or improvements in valuation [Reuters platform etc.]) have been implemented, and participants thought that policymakers should take try to keep abreast with these developments and take them into account in their deliberations.