

Restoring confidence in financial systems

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The Financial Crisis and the Requirements of Reform

The analogy that best fits the global financial crisis is one of a dam filled to overflowing, past the red danger line beyond which it may break. This of course is the global liquidity situation prior to August 2007. At the level of the global financial system, the basic problem has been the undervaluation of Asian (managed) exchange rates that have led to trade deficits for Western economies, forcing on them the choice either of macro accommodation or recession. The choice of easy money policies, to which political choices must always be biased, results in excess liquidity, asset bubbles and leverage.

Water of course always finds its way into cracks and faults, as anyone who has owned a leaky home will know. It causes damage and eventually forces its way through the wall. The dam wall may collapse. These 'faults and cracks' are the incentives built into capital regulations (such as Basel I and II) and tax rates, that led to a too-low cost of capital and to arbitrage opportunities for traders that were levered up many times to generate strong fee and profit growth, while longer-run risks were transferred to someone else.

The too low cost of capital in the regulated banking sector, high-return arbitrage activities and SEC rule changes in 2004 that allowed investment banks much more scope to expand leverage sharply, meant that these high-risk businesses became much bigger than they would have been with a higher cost of capital and better regulation. That is, systemically important ('*too big to fail*') financial firms emerged, as a direct consequence of policy, with excess leverage and lots of concentrated risk on their books.

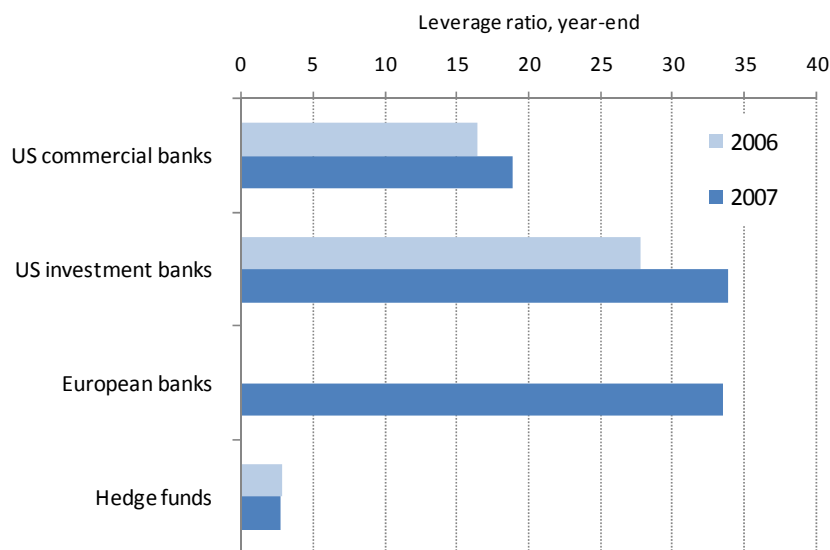
The poor governance of companies exacerbated this process. The model of banking changed for many institutions from a 'credit model'—kicking the tyres and lending to SME's and individuals that can't raise money in the capital markets—to a model that was based on the capital markets. An equity culture in deal making through securitisation, the creative use of derivatives and financial innovation emerged. Competition in the securities business increased (keeping up with the *trail blazers*), as companies taking the 'low hanging fruit' outperformed their peers, and staff benefited through bonuses and employee stock ownership programs.

The result has been the emergence of excess leverage and the concentration of risks.

Leverage ratios just prior to the crisis are shown in Figure 1. US banks, with an average leverage ratio of 18 proved to have too little capital. US investment banks under new SEC regulation post 2004 moved towards very high leverage levels of around 34, not unlike those in Europe, where capital levels are relatively low.

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Figure 1: Selected Leverage Ratios Prior to the Crisis



Source: Thomson, OECD.

Once defaults began (the ‘faults in the dam’ opening up) a solvency crisis emerged—losses outweighing the too-little capital that banks had—amongst highly-interconnected (‘too big to fail’) banks with business models that depended on access to capital markets. Once a buyers strike emerged (with uncertainty about who ‘was’ and ‘was not’ solvent) a fully-fledged financial crisis was under way.

When this occurs, any number of things that give rise to an investor environment that is hard to read and full of ‘potholes’ may occur:

- Banks go bust: in banking conglomerates via contagion risk (as losses in risky areas, like investment banking, have to be absorbed by safer parts of the business, but become too overwhelming to do so); in mortgage specialists and stand-alone investment banks that have too-concentrated risks; and in banks that were counterparties to derivative trades with problem banks and insurance companies. Panic rises and the crisis spreads.
- Liquidity risk rises as business models with short funding of long assets face a buyers strike at the short end, equally leading to bank failures.
- Regulators and supervisors come under extreme pressure and mistakes occur, particularly where there is overlapping regulatory structures and responsibilities.
- Failing banks get merged into other banks, which may save the failed bank for a short time, but weaken the stronger bank (*two ‘turkeys’ don’t make an ‘eagle’*) as there is no new net capital. This inevitably means the taxpayer has to come to the rescue anyway, leaving the country with a big actual and/or contingent tax liability as well as a larger *too-big-to-fail-bank* for the future.
- Banks have to be saved by injections of taxpayer money—the government buys a common equity stake or preferred equity with warrants; or opts to guarantee deposits and assets. This can happen in a reasonably open and transparent way, or quietly behind the scenes (as is the way in many European countries). Of course non transparent approaches make the terrain very difficult for investors—buying shares of a bank in the belief it is good value on the basis of available information, only to see it all wiped out to zero a month or two later, can be sobering to say the very least.

- The affected banks (and others) tighten lending standards and begin deleveraging (cutting their assets outstanding not supported by tier 1 capital), which is the main way the crisis hurts the economy. Recessions emerge, with trade spill-over effects pulling economies with sound economic management into the crisis.
- Struggling banks cut dividends, as they divert earnings to capital building and provisioning for losses, so erstwhile investors may face not only dilution risk (as new shares are issued) but income risk too. The only reason to buy a bank share in a crisis country in the early stage of this situation is if its balance sheet can survive and if it has been oversold. Otherwise it is better to wait until the crisis has passed, dividends are restored and buy-backs may begin to occur.
- Interest rates are savagely cut by central banks and liquidity policies are expanded, to do 3 basic things: (i) to ease liquidity pressures by providing a market for securities when banks won't trade with each other—i.e. to deal with the buyers strike that emerges when there is uncertainty about solvency; (ii) to raise the profitability of banks (they can borrow at zero and lend above zero for customers still being serviced) which raises underlying profitability helping banks build capital; and (iii) to support the economy (though in reality this is the classic pushing on a string scenario, where the price of new loans doesn't have much effect on supply and demand as falling confidence and deleveraging dominate).
- 'Bad' assets are placed on the public balance sheet in the form on loans and guarantees, which have to be unwound in the longer-term exit strategy.
- Budget deficits soar, as growth reverses and as governments act to support the economy, and have to be reversed in a world where trend growth will likely be slower—making the task very difficult indeed.

Table 1 shows the headline support for the financial sector in OECD countries. Australia stands out as one of the best countries in the OECD, a result of its very strong macro credentials (starting with a budget surplus and higher non-distorted interest rates), a sound twin-peaks regulatory structure (ASIC and APRA), with the central bank not responsible for prudential management (focusing on monetary policy, lender-of-last-resort and the stability of the payments system); and sound competition policy with the "Four Pillars" approach to our major banks (medium-sized oligopolies that did not compete excessively). Australia also had 2 pieces of good luck: (i) US and European investment banks take a lot of the local business and their problems became a US/European policy concern, and (ii) Australia is tied into the Asian economic region with better fundamentals than the US or Europe. The United States, on the other hand, has built up obligations equal to nearly 75% of GDP, and the European numbers are also very large, and likely understated—this is because European problems are less transparent in reporting and in the way crises are handled. In some EU countries this problem is compounded because losses often accrue to state-run banks where the crisis manifests itself as future tax contingent liabilities

Table 1: Headline Support for the Financial Sector and Upfront Financing Need

(% of GDP, as of Early 2009)

	Capital injection (A)	Purchase of assets and lending by Treasury (B)	Central Bank Supp. prov. With Treasury backing (C)	Liq. Provision and other supp. By central bank (a) (D)	Guarantees(b) (E)	TOTAL A+B+C+D+E	Up-front Govt. Financing Financing (c)
OECD members							
Australia	0	0.7	0	0	n.a.	0.7	0.7
Austria	5.3	0	0	0	30	35.3	5.3
Belgium	4.7	0	0	0	26.2	30.9	4.7
Canada	0	8.8	0	1.6	11.7	22	8.8
France	1.2	1.3	0	0	16.4	19	1.5(d)
Germany	3.7	0.4	0	0	17.6	21.7	3.7
Greece	2.1	3.3	0	0	6.2	11.6	5.4
Hungary	1.1	0	0	4	1.1	6.2	1.1
Ireland	5.3	0	0	0	257	263	5.3
Italy	1.3	0	0	2.5	0	3.8	1.3(e)
Japan	2.4	6.7	0	0	3.9	12.9	0.2(f)
Netherlands	3.4	2.8	0	0	33.7	39.8	6.2
Norway	0	13.8	0	0	0	13.8	13.8
Poland	0.4	0	0	0	3.2	3.6	0.4
Portugal	2.4	0	0	0	12	14.4	2.4
South Korea	2.5	1.2	0	0	10.6	14.3	0.2(g)
Spain	0	4.6	0	0	18.3	22.8	4.6
Sweden	2.1	5.3	0	15.3	47.3	70	5.8(h)
Switzerland	1.1	0	0	10.9	0	12.1	1.1
Turkey	0	0	0	0.2	0	0.2	0
United Kingdom	3.5	13.8	12.9	0	17.4	47.5	19.8(i)
United States	4	6	1.1	31.3	31.3	73.7	6.3(j)
Non-OECD G20 members							
Argentina	0	0.9	0	0	0	0.9	0.0(k)
Brazil	0	0	0	1.5	0	1.5	0
China	0.5	0	0	0	0	0.5	0.0(l)
India	0	0	0	5.6	0	5.6	0
Indonesia(m)	0	0	0	0	0.1	0.1	0.1
Russia	0.1	0.4	2.9	3.2	0.5	7.1	0.6(n)
Saudi Arabia	0.6	0.6	0	8.2	n.a.	9.4	1.2
G-20 average(o)	1.9	3.3	1	9.3	12.4	27.9	3.3
<p>a) This table includes operations of new special facilities designed to address the current crisis and does not include the operations of the regular liquidity facilities provided by central banks. Outstanding amts. under the latter have increased a lot, and their maturity has been lengthened recently (inc. ECB)</p> <p>b) Excludes deposit insurance provided by deposit insurance agencies.</p> <p>c) This includes components of A, B and C that require upfront government outlays.</p> <p>d) Support to the country's strategic companies is recorded under (B); of which EUR14 bn will be financed by a state-owned bank, Caisse des Dépôts et Consignations, not requiring upfront Treasury financing.</p> <p>e) The amount in Column D corresponds to the temporary swap of government securities held by the Bank of Italy for assets held by Italian banks. This operation is unrelated to the conduct of monetary policy which is the responsibility of the ECB.</p> <p>f) Budget provides JPY 900 bn to support capital injection by a special corp. and lending and purchase of comm. paper by financing institutions of the BoJ.</p> <p>g) KRW 35.25 tn support for recapitalisation and purchase of assets needs upfront financing of KRW 2.3 tn.</p> <p>h) Some capital injection (SEK50 bn) will be undertaken by the Stabilisation Fund.</p> <p>i) Costs to nationalise Northern Rock and Bradford & Bingley recorded under (B), entail no upfront financing.</p> <p>j) Some purchase of assets and lending is undertaken by the Fed, and entails no immediate govt. financing. Upfront financing is USD 900 bn (6.3% of GDP), consisting of TARP (700 bn) and GSE support (200 bn). Guarantees on housing GSEs are excluded.</p> <p>k) Direct lending to the agric. and manuf. sectors and consumer loans are likely to be financed through Anses, and wont require upfront Treasury financing.</p> <p>l) Capital injection is mostly financed by Central Huijin Fund, and would not require upfront Treasury financing.</p> <p>m) Extensive intervention plans that are difficult to quantify have also been introduced recently.</p> <p>n) Asset purchase will be financed from National Wealth Fund; and the govt. will inject RUB 200 bn to deposit insurance fund financed from the budget.</p> <p>o) PPP GDP weights.</p>							

Source: OECD

The problems the world faces in dealing with this crisis are far from over. The lessons of all past crises of the solvency kind are threefold:

1. Guarantee deposits to stop runs on banks.
2. Remove toxic assets from bank balance sheets. These should be dealt with in a "bad bank" over a number of years, with the aim that hold-to-maturity values might be better than current mark-to-market values of illiquid toxic assets.
3. Recapitalise asset-cleansed banks, and get out (sell the government's holdings of shares and transfer any loans and guarantees from the public balance sheet back to the private sector).

Where are we in this process? And how optimistic can we be? Unfortunately the answer is not far in the process and we face a very long period of slow growth as budget deficits are stabilised and slowly reduced in unfavourable circumstances. The reason for this is that countries have not yet dealt with step 2. In the US a PPIP (public-private investment plan) has been conceptualised (a reasonably good plan) but little has happened. Within Europe, Switzerland moved on toxic asset of UBS, but only a couple of EU countries have even started to conceptualise 'bad banks'; nothing yet has happened.

Less transparent approaches do not change anything—it is like losing your job and trying to hide it from your family: it always catches up with you anyway, and you may make it worse for yourself. Banks know the facts and they won't lend anyway if they have no capital and are dealing with regulators behind the scenes about restructuring their balance sheets. Deleveraging continues, which is why some countries see GDP falling more quickly than in other countries, even as they try to say the centre of gravity of the crisis lies elsewhere. Lack of transparency can result in delays in policy action and bigger losses in the end for taxpayers. It will also result in bad-will from investors and a permanent rise in the cost of capital: the political risk premium from investing in financial firms will rise. Firms making investments in problem financial firms on the basis of incorrect information, for example, can end up losing their investment, sending a negative message about investing in non-transparent regions.

Hypo real estate illustrates many (though not all) aspects of the above discussion. It had assets at the end of 2007 of \$402 billion Euros, risk-weighted asset of 100 billion Euros, and Tier 1 capital of only 5.5 billion Euros—this looked good under Basel capital rules but was nothing like the capital the group would need in the end—its leverage ratio was staggering 73 times. It issued covered bonds to reduce capital requirements even further in the anticipation of Basel II, and therefore had big CDS exposures (often to State-owned German banks). It was brought undone through contagion risk from its subsidiary Depfa, where short-covered bonds were issued to fund long-term assets on the balance sheet (liquidity risk). This small collapse alone will risk costing the taxpayer a lot of money and recent investors have lost their capital.

In short, there is a long way to go before the strategies to exit from the extraordinary crisis measures taken can be contemplated, and weak lending by banks combined with easy monetary and fiscal policies is a dangerous cocktail.

The carry trade has already begun again (commodities and some emerging market equities now bubbling back up via this mechanism), and the reform process is moving slowly and sometimes not in the right directions. This means that support policies risk staying in place too long, while slower growth will make it harder to reduce budget deficits.

Requirements of Reform and Exit from Extraordinary Policies

The exit strategy requires us to think about '*exit to what*'—surely not to similar incentive structures to the ones in place prior to the crisis! A sound framework, at the most basic level, requires some very basic building blocks that all jurisdictions should work to have in common. These most basic things are:

- The need for a lot more capital—so that reducing the leverage ratio has to be a fundamental objective of policy. Europe has a very long way to go in this respect if there is to be some equalisation across the globe.
- The elimination of arbitrage opportunities in policy parameters to remove 'subsidies' to the cost of capital. This means many features of the Basel system for capital rules should be eliminated (and in any case the leverage ratio may well become the binding constraint, as

recommended in the Turner Report and in the OECD)². It also means looking at the way income-, capital gains- and corporate tax rates interact with financial innovation and derivatives to create concentrated risks and to eliminate ways to profit from such distortions.

- The necessity to reduce contagion risk within conglomerates, with appropriate corporate structures and firewalls. This issue is not unrelated to the ‘too big to fail’ moral hazard problem. It must be credible that affiliates and subsidiaries of large firms cannot risk the balance sheet of the entire group—they can be closed down by a regulator leaving other members of the group intact.
- The avoidance of excessive competition in banking/securities businesses (the ‘*keep on dancing*’ problem) and a return to more emphasis on the ‘credit culture’ banking model. The stable oligopolies in Australia and Canada have been resilient in the current crisis lending support to this idea.³
- Corporate governance reform is required, with the OECD recommending: separation of CEO and Chairman (except for smaller banks where the CEO is the main shareholder); a risk officer reporting to the board and whose employment conditions do not depend on the CEO; a fit and proper person test for directors expanded to include competence, and fiduciary duties clearly defined. These reforms would go a long way to dealing with remuneration issues that have been strongly debated of late.
- The need to rationalise the governance of regulators in some key jurisdictions who failed dismally in the lead up to this crisis. The benchmark for a sensible regulatory structure is the ‘twin peaks’ model—a consumer protection and corporate law regulator and a separate prudential regulator. Central banks should not be a part of either. This leads to conflicts of interest. Central banks conduct monetary policy, and should be focused on avoiding excess liquidity and bubbles that cause financial crises (which often precede inflation pressure); their purview in financial stability does not extend beyond monetary policy, the lender-of-last-resort function and the maintenance of stability in the payments system.

However, it seems very unlikely that these building blocks will be in place any time soon—if only because many governments do not even accept all of them as desirable features. The starting point is always the rules and regulations and institutional structures at the starting point, and the process of change is always at the margin. Groupthink implicit in economic and market paradigms, unfortunately, takes a long time to change.

So exiting from government ownership of banks, and from guarantees and loans and other forms of aid, will likely occur in a second-best environment. Toxic assets and recapitalisation will be dealt with slowly, and the drain on bank earnings and share dilution will work against a rapid exit from extraordinary crisis measures. The exit strategy process (i.e. the transferring stock and debt from the public to the private balance sheet and cutting budget deficits) will risk more financial price volatility. One can be even less optimistic about the reform of global exchange rate regimes and the dollar reserve currency problem. Easy liquidity and carry trades will provide short-run opportunities for quick returns, but slow economic growth and rate pressures will persist. In short, a very challenging time for investors is likely to be around for some considerable while yet.

² Financial Services Authority, The Turner Review: a regulatory response to the global banking crisis, including Discussion paper 09/02, March 2009. See “Finance, Competition and Governance: Priorities for Reform and Strategies to Phase Out Emergency Measures”, paper prepared for the OECD Ministerial Meeting, June 2009.

³ As argued by Ian Macfarlane at the recent ASIC conference