European Shadow Financial Regulatory Committee

Statement No. 27

Brussels, March 10, 2008

Resolving the Current Crisis and Preventing its Return

I. Radical disclosure entailing full loss recognition

There is no sign that the subprime crisis is coming to an end. Evidence for this includes the recent rewidening of spreads in the interbank market, manifesting uncertainty regarding counterparty creditworthiness, as well as ongoing disclosure of major losses by global banks. Losses have lowered equity levels in a number of banks that had hitherto appeared to be comfortable. Although some banks have succeeded in raising new capital, notably from sovereign wealth funds, these new equity injections are far from sufficient given the scale of the problem. The wider economy is facing tighter credit conditions, which although partly warranted are aggravated by the prevailing uncertainty and illiquidity of markets.

We contend that further action by policymakers and banks is required in order to resolve the current crisis, and this cannot be limited to generous overnight financing by central banks, because it neither resolves the problem of uncertainty nor that of bank capital. Some additional ideas are circulating such as stepping back from recent progress in terms of disclosure and transparency, with partial abandonment of marking to market accounting in favour of book values. We reject such suggestions as being inconsistent with appropriate incentive-compatibility.

In our view, the key to resolution is a complete recognition of losses as they can be valued today via a radical disclosure policy. These losses comprise two components; permanent credit impairment (reflecting for example defaults on subprime mortgage loans); and what is largely temporary illiquidity depressing prices for all kinds of securitized financial assets. Both kinds of losses are a consequence of past errors by bank managers in a scenario when credit was underpriced and liquidity was abundant. In a capitalist market system, it is clear that the consequences of such losses need to be borne by those making them and by the ultimate owners of the institution.

We would envisage that the outcome of such radical recognition of losses would actually be benign, since it would open up avenues for keeping these losses within limits. Many banks already have sufficient capital to cover such losses, while most of the other banks will be able to raise new capital, to an extent sufficient to put their creditworthiness

beyond doubt. This and the elimination of uncertainty from full disclosure would in turn help to remove the liquidity problem in the interbank market. It would also favour the revaluation of outstanding assets, as a revival of liquidity would spread to the asset backed commercial paper market and the market for securitized assets with longer maturities.

The incentives for such a full and early recognition of losses are not strong for an individual bank, and even for the industry as a whole. In effect, bank managers may well resist the devaluation of their stock options, and owners might resist the dilution of their current equity holdings. This means that firm action is required by regulators and central banks – preferably in cross-border co-operation - to mandate radical disclosure by all major banks in a limited period of time. The authorities should firmly resist self-interested pleas by bankers for less radical policies that would entail a "privatization of gains and socialization of losses".

We recognize that radical disclosure and full loss recognition would not be without risk. Central banks should in our view stand willing to provide ample liquidity at longer maturities such as 3 or 6 months to banks willing to undertake radical disclosure. If removal of uncertainty itself helps to resolve the current problems of the interbank market, the amount of such central bank financing could be limited. Some banks might need a merger, public administration or even closure; but this need not entail a net social loss as long as appropriate systemic safeguards are in place.

II. Due diligence and distorted incentives in the current crisis

In the current crisis, highly leveraged asset backed securities have been bought to an amazing extent by highly sophisticated financial institutions. For 2007, some of them had to write down more than 20 billion dollars each. This may include some losses which are not connected to high risk home loans, but there is no doubt that the problems result primarily from the collapse of the subprime mortgage market. Thus, the question arises of why and how these and other financial firms accumulated such enormous amounts of highly problematic securities. The answer is complex, but one element of it is the weakness of in-house analysis before making the huge investments. Looking at this weakness serves to illustrate the role that distorted incentives play in the current crisis.

There are strong indications that due diligence has declined. Clayton Holdings, a firm specialized in rendering due diligence reports to investment banks with regard to residential mortgage loans and the biggest provider of this service in the US, reported that, starting in 2005, it observed a significant deterioration of lending standards. With the growing demand for residential loans, mortgage companies were in a strong enough position to stipulate that investment banks have Clayton and other consultants look into fewer loans. It appears that the lenders wanted due diligence to find fewer problem loans which would have to be sold at a discount. Clayton reported in addition that investment banks did not pass the due diligence reports on to the rating agencies.

This story suggests a somewhat paradoxical situation. On the one hand, the instruments of structured finance have become inherently less safe for investors, and the increasing risks were disguised by more and more complex and opaque arrangements. At the same time, due diligence was systematically reduced.

There are several ways to explain this phenomenon, and they are not mutually exclusive. Many of the players in the field are big institutions characterized by complex organizational structures, a high degree of specialization to perform very specific services, incentive compensation based on short term results, and significant job mobility. Such an arrangement generates incentives to increase volume and risk regardless of the medium or long term consequences. When the losses occur, the responsible agents have cashed their bonuses and moved to other functions or institutions. Another explanation is disaster myopia, the often observed tendency to under-estimate the probability and the consequences of low frequency adverse shocks. And there may also be the consequences of herding behavior: the fact that others have done the same serves as a defense against ex post recriminations. These phenomena are interconnected, disaster myopia and herding behavior can be reinforced by institutional arrangements.

This experience raises the question of whether and to what extent top management and possibly the board of financial institutions should be held responsible for inadequate organizational structures which discourage employees from observing adequate due diligence and risk assessment practices. The increasing lack of due diligence is just one of several instances in which inappropriate incentives have contributed to the emergence of the crisis.

We therefore recommend that, following the logic of Pillar II of the Basel II Accord, bank supervisors should have a closer look into the risk implications of the organizational structures that banks and other financial service firms put in place. Features like the systematic disregard of due diligence require the attention and, where necessary, the intervention of authorities having responsibility for the functioning of financial markets and for systemic stability.

III. Preventing future crises

The current crisis clearly shows the importance of having a well conceived and coherent system and an institutional structure that help to prevent such crises from occurring in the first place and to resolve a crisis once it has occurred. Currently, such a system does not exist, either at the EU level or at the international level. In the course of the past ten years, the ESFRC has issued a number of statements that advocate putting in place structures that can be regarded as core elements of such a coherent system. They include the following recommendations, which we want to restate at this point:

A “European Banking Oversight Board”, should be created as an institution that is independent of national regulators and supervisors and has the function of regularly observing the development of systemic risk of banks in Europe, as we recommended in

our statement issued in October 1998. The present situation makes it obvious how problematic the lack of such a European-wide oversight is.

With regard to deposit insurance in Europe, immediate payout should be the in times of crisis in order to reduce the risk of runs as occurred in the Northern Rock case. Moreover a similar level of deposit insurance should be, in all European countries; and it should be high enough to enable national authorities to accept the political consequences of a bank's failure, as we argued in our statement from October 1999.

A system of Structured Early Intervention and Restructuring (SEIR) or, to use the American term Prompt Corrective Action (PCA), should be put in place as part of the supervisory process in each individual Member State. SEIR denotes an approach in which certain indicators of capital adequacy of banks trigger predetermined supervisory measures as under the PCA rules in the US. Such procedures would reduce the likelihood of a sudden banking crisis and, in the case of cross-border banking, contribute to host country supervisors' trust in home country supervisors, as we argued in our first statement issued in June 1998.

We propose once more, as we did in November 2005, to create a European Standing Committee for Crisis Management (akin to the UK tripartite Standing Committee) to alleviate some of the shortcomings of the present system of handling a possible pan-European financial crisis, since we believe that the current structure is inadequate. Currently, national authorities from the 27 Member States of the EU meet in a multiplicity of regulatory and supervisory committees, often with overlapping responsibilities. Despite the plethora of committees, specific institutional arrangements to deal with crisis management at the European level appear to be insufficient and, in any event, are not transparent. Fortunately, during the current crisis, bank failures have so far only taken place within national jurisdictions; but the possibility of a failure with severe cross-border implications should be taken into account urgently.

Finally, the current events demonstrate rather clearly that the main thrust of the Basel II Accord has serious shortcomings. One reason is that the new capital regulation is likely to reduce the capital requirement for many large banks, thereby increasing the vulnerability of these banks to major shocks and reducing systemic stability. We have used this and a number of other arguments in a series of statements since 2001 to warn against overestimating the merits of the Basel II approach.