The recent financial turmoil: policy and regulatory initiatives to enhance the resilience of the global and European financial system

Christos Vl. Gortsos
Assistant Professor of International Financial Law,
Panteion University of Athens,
Secretary General, Hellenic Bank Association
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A. The "originate and distribute" banking model: securitization and beyond

- Securitisation (the "originate and distribute" banking model): the basic structure
  - A bank or a finance company (originator) grants a loan to a borrower
  - The originator sells a pool of loans to a special purpose vehicle (SPV)
  - The SPV funds itself by issuing debt (asset-backed securities, ABSs)
  - The rating of the debt is conducted mainly by credit rating agencies (CRAs)
  - The interest payment to investors (bondholders) depends on timely interest income from ultimate borrowers – the investor cannot monitor the ultimate borrowers
  - ABSs are distributed by investment banks usually to institutional investors
  - Typically there is no secondary market for the trading of ABSs

A. The "originate and distribute" banking model: securitization and beyond

- Securitisation: the positive contribution
  - Reduction of credit risk in bank portfolios – in the presence of capital adequacy regulations, relief of own funds to be allocated for other productive investments
  - Higher liquidity in bank portfolios (loans are in general non-liquid, unless securitized)
  - Reduction of maturity mismatches in bank portfolios
  - Demand for ABSs by institutional investors seeking higher yields than government and some corporate bonds as well as portfolio diversification

A. The “originate and distribute” banking model: securitization and beyond

- The second wave of securitizations: the creation of “structured credit instruments”
  - The typical instrument: “collateralized debt obligations” (CDOs) – there exist also CDOs of CDOs (so called “CDO-square”)
  - The vehicle issuing CDOs (its liabilities side) is putting together (on its assets side) bonds from different securitized loan portfolios
  - The new portfolio is structured in different parts (“tranches”) with different credit risk exposures
  - Each part can be sold to investors with different degree of risk appetite (or risk aversion)
  - The incoming interest income is distributed according to the seniority of the tranches – investment in junior tranches is riskier, hence interest payment higher
  - At the bottom of the structure: an “equity tranche” usually held by originators

A. The "originate and distribute" banking model: securitization and beyond

- Disadvantages of CDOs
  - Difficult to assess credit risk in the various tranches of the CDOs - investors rely almost entirely on the ratings provided by credit rating agencies (CRAs)
  - CDOs are not listed
    - Irregular trading – low degree of liquidity
    - Valuation by using models created by CRAs

B. The emergence of bank-owned “special investment companies”

1. Types of special investment companies

- Conduits
- Structured Investment Vehicles (SIVs) (highly levelaged)

2. Investment policy of special investment companies

- Holdings in CDOs (longer-term illiquid assets)
- Funding by issuing short-term Asset-Backed Commercial Papers (ABCPs)

B. The emergence of bank-owned "special investment companies"

3. The role of parent banks

- The motive: banks overcome stringent capital adequacy requirements
- The obligation: banks guarantee the ability of Conduits and SIVs to repay their debts to investors (holders of ABCPs), if the latter are unable to issue new papers in the market (liquidity guarantee, contingent liquidity facilities and lines)
- (Off-balance-sheet) holdings in Conduits and SIVs are not disclosed

C. The weakest link in the chain: the US "sub-prime" mortgage credit market

1. Characteristics of US sub-prime mortgage loans

- Mortgage loans granted to households with particularly weak credit record and economic fundamentals
- "Short-reset" loans
- 13% of total mortgage loans in the US

2. The problems that have arisen out of the US sub-prime mortgage loans

- Necessary to conduct proper credit assessments on borrowers in order to differentiate the interest rates charges – this did not happen
- When interest rates started rising, many borrowers started defaulting on their loans sometimes even before the reset

D. The triggers of the financial turmoil

1. The initial events:

- In summer 2007 it became evident that defaults on US sub-prime mortgage loans would be higher than expected
- Hedge funds tied to Bear Stearns went bankrupt because they could not dispose of CDOs containing sub-prime mortgage loans in order to meet investor demand for liquidity
- CRAs downgraded CDOs containing sub-prime mortgage loans – confidence in the market for the securitisation of mortgage credit, in general, was shaken

D. The triggers of the financial turmoil

2. Impact on banks:

- Investors in ABCPs lost their confidence, as well, and the demand for these debt instruments fell (flight to quality)
- Parent banks of Conduits and SIVs were forced to fulfil their obligations from liquidity guarantees – in most cases the extent of the true exposure to the risk was unexpected
- Two German banks (IKB and Sachsen Landesbank) announced to have suffered substantial losses from their holdings in Conduits

D. The triggers of the financial turmoil

3. The reaction of banks and the impact on the interbank market:

- Those with holdings in Conduits and SIVs needed liquidity in order:
  - to meet obligations from liquidity guarantees, and/or
  - transfer the underlying assets in their balance sheet (affecting also their capital adequacy ratios)
- Those without holdings were reluctant to lend in the interbank market due to the lack of transparency with regard to other banks' exposure to liquidity risk
- The cumulative effect: interest rates in the unsecured interbank market rose sharply
- Banks depending on longer-term market financing suffered losses: Northern Rock witnessed the first "bank run" in decades in a country with an explicit deposit guarantee scheme

D. The triggers of the financial turmoil

4. The reaction of central banks:

- Central banks intervened, in a concerted way, in order to provide liquidity and reduce the volatility in short-term interest rates
- Some central banks (U.S. Federal Reserve) even reduced the rate in their main refinancing operations, while other (ECB) did not raise this rate as anticipated

5. “Crisis of confidence” on CRAs as to their ability to properly grade structured products

II. Policy and regulatory initiatives

Areas for policy action and regulation

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D. Operational conditions for OTC derivatives

E. Assessment (and possible strengthening) of capital requirements

F. Liquidity risk management (LRM)

G. Review and strengthening of deposit guarantee schemes

A. Transparency in securitization processes and markets

(i) Pillar 3 securitization disclosures

- The objective of the overall disclosure component within the Basel II framework, commonly known as Pillar 3, is to encourage market discipline by developing a set of disclosure requirements which allow market participants to assess key pieces of information on the capital, risk exposures, risk assessment processes, and hence the capital adequacy of the credit institution.

- Experience resulting from the financial turmoil that originated from the deterioration of the U.S. subprime mortgage market has further highlighted the importance of disclosure for the securitization business.

A. Transparency in securitization processes and markets

(i) Pillar 3 securitization disclosures

- **International level**
  - Basel Committee on Banking supervision announced (16.04.2008) that it will promote enhanced disclosures relating to:
    - complex securitization exposures,
    - ABCP conduits, and
    - the sponsorship of off-balance sheet vehicles.

Enhanced disclosures in these areas could help to avoid a recurrence of market uncertainties about the strength of banks' balance sheets in the event of a future episode of market turmoil (finalization in 2009).

A. Transparency in securitization processes and markets

(i) Pillar 3 securitization disclosures

- **EU level**
  - Under the aegis of the EU Industry Roundtable on Securitization Transparency, the European industry is working on a set of ***Good practice guideline for Pillar 3 disclosures***
  - Primary focus on promoting sound, consistent and appropriately granular implementation of the Capital Requirements Directive (CRD) disclosure requirements relating to securitization (finalization by 31 October 2008)

A. Transparency in securitization processes and markets

(ii) Supplementary risk disclosures

Supplementary disclosures are intended to supplement rather than replace existing risk disclosures, including those required under Pillar 3 of Basel II.

- **International level**
  - The Financial Stability Forum (FSF) encouraged financial institutions to make robust risk disclosures using the leading disclosure practices for selected exposures (SPEs, CDOs, RMBSs, CMBSes) at the time of their mid-year 2008 reports.
  - FSF will assess the results of supplementary risk disclosures in September 2008.

A. Transparency in securitization processes and markets

(ii) Supplementary risk disclosures

- **EU level**

In the same line with the Financial Stability Forum:

  - *“The EU Council recalls that prompt and full disclosure by banks and other financial institutions of their exposures to distressed assets and off-balance sheet vehicles and of their write-downs and losses is essential to bring back confidence in the markets. In this respect, the Council underlines that the upcoming mid-year results need to be as comprehensive, legible and comparable as possible”* (08.07.2008)

A. Transparency in securitization processes and markets

(iii) Industry initiatives

1. Information to be provided to policymakers

Market participants by expanding information on securitized products and their underlying assets, will assist policymakers in their monitoring and assessing of trends in the primary and the secondary securitization market.

- **EU level**
  - Under the aegis of the EU Industry Roundtable on Securitization Transparency, the European industry is working on a ***Securitization Data Report*** (SDR) and on a ***Secondary Market Holdings Report*** (SMHR).

Securitization Data Report (SDR)

- On 25 June 2008, trade associations participating in the EU Roundtable and responsible for the SDR (i.e. ESF, SIFMA, ICMA and CMSA) published the first issue.
- The SDR contains information on the main asset classes (RMBS, CMBS, ABS, CDOs and ABCP) for Europe and the US and precisely on:
  - term issuance activity (by collateral type, country of collateral and rating),
  - number of term securitization transactions by deal size,
  - term outstanding volumes,
  - ratings changes by country of collateral and by collateral type.
- It will be produced quarterly.

Secondary Market Holdings Report (SMHR)

- On 30 June 2008, the European Banking Federation presented to the European Commission the first issue of the SMHR. The SMHR provides:

  - information on holdings of securities and volumes,
  - data on volumes including both financing and sell transactions provided by ICSDs on the basis of transactions settled by them,

  Information is provided on an aggregate basis.

- The SMHR will be produced quarterly and will only be shared with officials from regulatory and supervisory authorities.

A. Transparency in securitization processes and markets

(iii) Industry initiatives

2. Information to be provided to investors

Market participants are taking initiatives to increase transparency of information on securitized products to be provided by issuers to investors.

- **International level**
  - The American Securitization Forum is developing templates for disclosures to investors about ABCP Conduits.
  - The Japan Securities Dealers Association, together with originators, arrangers, investors and the regulator, is making efforts to establish distributors' rules and a standardized format of disclosure of securitized products.

A. Transparency in securitization processes and markets

(iii) Industry initiatives

- **EU level**
  - Under the aegis of the EU Industry Roundtable on Securitization Transparency, the European industry on 12 June 2008, has finalized the ***ABCP Issuer Disclosure Code of Conduct***. The Code of Conduct will be voluntary.
  - The Code of Conduct is designed to ensure that investors in ABCP have access to information through different sources:
    - the information memorandum,
    - the monthly investor report,
    - investor meetings, and
    - rating agency reports.

A. Transparency in securitization processes and markets

(iii) Industry initiatives

- **EU level (cont.)**
  - The information should be reviewed by investors, both before buying and on an ongoing basis. Purchases should not be based on rating alone. Specifically, investors should know, monitor and be comfortable with: the type of assets financed, the sponsor of the programme, the sponsor’ s ability to administer the programme, the liquidity support and credit enhancement provided, and the mechanism for repaying the commercial paper should market conditions not permit rollover.

B. Valuation issues

(i) Guidance on accounting and disclosure for valuations

- **International level**
  - IASB:
    - Review of IFRS 7: disclosures to assess its effectiveness in ensuring that entities disclose information that reflects their exposures to risk and any potential losses arising from financial instruments with the off-balance sheet entities with which they are involved
    - Review Standard on consolidation of special purpose vehicles and other entities and related risk disclosures for off-balance sheet entities (SIC 12) (end of 2008)

B. Valuation issues

(i) Guidance on accounting and disclosure for valuations

- **International level (cont.)**
  - Basel Committee on Banking Supervision:
    - Guidance for supervisors to assess banks’ valuation processes (end of 2008).

Topics covered by the guidance will include:

(i) the quality of banks’ measurement tools and the appropriate use of a diverse set of valuation measures,

(ii) the robustness of banks’ assessments of valuation uncertainty, and

(iii) the quality of internal and external transparency.

B. Valuation issues

(i) Guidance on accounting and disclosure for valuations

- **International level (cont.)**
  - IOSCO has announced on 29 of May its tension for:
    - possible guidance and disclosure related to measurement at fair value from the perspective of investors' needs,
    - assessment of internal control's expertise on fair valuation modeling in illiquid market conditions.

B. Valuation issues

(i) Guidance on accounting and disclosure for valuations

- **EU level**
  - CEBS
    - Report on valuation of complex and illiquid financial instruments (18.06.2008). The report puts forward a number of issues that should be addressed by institutions and accounting and auditing standard setters to improve the reliability of the values ascribed to these instruments. It focuses on:

      (i) challenges for the valuation of complex financial instruments or instruments for which no active markets exist;

      (ii) transparency on valuation practices and methodologies as well as related uncertainty; and

      (iii) auditing of fair value estimates.

B. Valuation issues

(i) Guidance on accounting and disclosure for valuations

- **EU level (cont.)**
  - CESR
    - Assessment of valuation of illiquid financial instruments by listed companies.
    - The assessment focuses on the identification of active and non active markets and the use of valuation techniques. Also provides an example of how issuers could present a useful summary of their valuation procedures in tabular form.
    - CESR expects to publish the final document in October 2008.

B. Valuation issues

(ii) Industry-led improvements in valuation processes and disclosures

Financial institutions will work on three strands:

1. the establishment of valuation processes,
2. the maintenance of sound governance and control practices associated with those processes, and
3. the enhancement of the quality of valuation-related disclosures.

Under preparation: ***Investor Credit Assessment and Valuation Principles*** (end 2008).

C. Credit rating agencies

The reform of the function of credit rating agencies is necessary to:

- improve the quality of the rating process and manage conflicts of interest in rating structured products,
- differentiate ratings on structured finance from those on bonds and expand the initial and ongoing information provided on the risks of structured products, and
- enhance their review of the quality of the data input and of the due diligence performed on underlying assets by originators, arrangers and issuers involved in structured products.

C. Credit rating agencies

- **International level**
  - IOSCO
    - **Review of the *Code of Conduct Fundamentals for CRAs*** (28.05.2008)
    - Amendments have been made to the following sections:
      - quality and integrity of the rating process,
      - CRAs’ independence and avoidance of conflicts of interest,
      - CRAs’ responsibilities to the investing public and issuers, and
      - disclosure of the Code of Conduct and communications with market participants.

C. Credit rating agencies

- **International level (cont.)**
  - Committee on the Global Financial System (BIS)
    - Report on ratings in structured finance (04.07.2008)
      According to the recommendations of the Committee:

      (i) rating reports should be presented in a way that facilitates comparisons of risk within and across classes of different structured finance products,

      (ii) credit rating agencies should provide clearer information on the frequency of rating updates, and

      (iii) credit rating agencies should clearly and regularly disclose the economic assumptions underlying the rating of structured finance products.

C. Credit rating agencies

- **International level (cont.)**
  - SEC
    - Proposals for amendments on its Nationally Recognized Statistical Rating Organizations (NRSROs) (25.07.2008)
    - The proposals:

      (i) address conflicts of interest in the ratings process,

      (ii) mandate public reporting of specified ratings-related information by NRSROs, and

      (iii) require NRSROs to differentiate their ratings of structured products from their ratings of corporate debt.

C. Credit rating agencies

- **EU level**
  - CESR
    - Advice on the role of credit rating agencies in structured finance (20.05.2008)
      - highlights the need for CRAs to take appropriate action on an ongoing basis to ensure that they communicate clearly regarding the characteristics and limitations of the ratings of structured finance products,
      - urges CRAs to effectively resource themselves to ensure their ratings are, and remain, of a sufficient quality, and
      - acknowledges that a clearer international consensus over acceptable interaction between CRAs and issuers would be of benefit to the market.

C. Credit rating agencies

- **EU level (cont.)**
  - European Securities Markets Expert Group (EC)
    - Publication of a Report on the role of Credit Rating Agencies (09.06.2008). It focuses on the need for improvements to the following areas:
      - good corporate governance,
      - need to share more information in a more effective manner so that the users of credit ratings can better understand how the ratings are determined,
      - establish a centralized depository for ratings performance studies to allow easier market comparison among CRAs,
      - a more robust and enhanced IOSCO code should be adopted with appropriate and adequate transparency provisions with respect to CRAs compliance.

D. Improving of operational conditions for OTC derivatives

The objective is to improve the settlement, legal and operational infrastructure underlying OTC derivatives markets

- **International level**
  - IOSCO
    - Review of transparency requirements in trading and post trading issues
  - NY Federal Reserve Industry Grouping
    - Agenda for addressing weaknesses in the operational infrastructure of the OTC derivatives market:
      - establishment of a central clearing house for credit default swaps (CDS),
      - protocol for managing defaults, and
      - greater automation of trading and settlement.

E. Assessment (and possible strengthening) of capital requirements

Assessing the impact of Basel II implementation will help supervisors to decide whether additional capital buffers are needed.

- **International level**
  - Basel Committee on Banking Supervision
    - Impact assessment of Basel II implementation (until the end of 2008)
    - Later in 2008 proposals for:
      - establishing higher capital requirements for complex structured credit products,
      - strengthening the capital treatment of liquidity facilities extended to off-balance sheet vehicles,
      - strengthening the capital requirements in the trading book.

E. Assessment (and possible strengthening) of capital requirements

- **EU level**
  - Review of the Directives 2006/48/EC and 2006/49/EC on:
    - large exposures,
    - hybrid capital instruments,
    - supervisory arrangements,
    - waivers for cooperative banks organized in networks, and
    - adjustments to certain technical provisions.
  - EC proposal for the Directive amending the abovementioned Directives is scheduled to be submitted in September 2008

F. Guidance on liquidity risk management (LRM)

Global sound practice standards for liquidity risk management and supervision must be strengthened.

- **International level**

  Basel Committee on Banking Supervision

  - Global Principles for sound LRM and supervision (September 2008): the Basel Committee has conducted a fundamental review of its 2000 Sound Practices for Managing Liquidity in Banking Organizations.

F. Guidance on liquidity risk management (LRM)

Guidance of BCBS has been significantly expanded in a number of key areas. In particular, more detailed guidance is provided on:

- the maintenance of an adequate level of liquidity, including through a cushion of liquid assets,
- the necessity of allocating liquidity costs, benefits and risks to all significant business activities,
- the identification and measurement of the full range of liquidity risks, including contingent liquidity risks,
- the design and use of severe stress test scenarios,
- the need for a robust and operational contingency funding plan, and
- the management of intraday liquidity risk and collateral.

F. Guidance on liquidity risk management (LRM)

- **International level**
  - IOSCO
    - Survey on members' experience on liquidity risk management and liquidity standards (29.05.2008)

- **EU level**
  - CEBS
    - Public consultation on its technical advice on liquidity risk management by credit institutions and investment firms and the supervision of liquidity risk

G. Review and strengthening of deposit guarantee schemes

- **International level**
  - International Association of Deposit Insurers (IADI)
    - ***Core Principles for Deposit Insurers*** (29.02.2008)
    - IADI has developed the Core Principles for the benefit of countries considering the adoption or the reform of a deposit insurance system. The Core Principles are designed to enhance the effectiveness of deposit insurance systems and are based on IADI research and guidance papers
    - The 21 Core Principles are intended as a voluntary framework for effective deposit insurance practices. National authorities are free to put in place supplementary measures that they deem necessary to achieve effective deposit insurance in their jurisdictions.

G. Review and strengthening of deposit guarantee schemes

- **EU level**
  - European Commission
    - Review of Deposit Guarantee Schemes Directive (94/19/EC)
  - European Forum of Deposit Insurers
    - Publication of three self-regulatory initiatives (September 2008 and 2009) on the following issues:
      1. scope of the current definition of deposits,
      2. information exchange with and between DGS,
      3. risk based elements,
      4. best practice concerning the improvement of consumer information on DGS,
      5. duration of payment delays to depositors.

CHART ON THE GLOBAL FINANCIAL REGULATORY/SUPERVISORY STRUCTURE