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# The Financial Industry and Challenges Related to Post-Crisis Exit Strategies

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*Financial markets have recovered substantially but vulnerabilities remain significant. Ample liquidity may lead to new bubbles, particularly in some emerging markets, and uncertainties about government exit strategies and regulatory changes threaten a fledgling upswing. Co-ordination and communication of exit policies will be important, and exit from policy stimulus should not be precipitated at the current juncture. While financial institutions have increasingly obtained market financing and paid back state aid, the sector remains fragile; thus, such voluntary pay-backs should meet preconditions aimed at ensuring the soundness and sustainability of the concerned institutions' balance sheets. At the same time, expectations of future writedowns and more stringent capital rules put pressure on bank lending more generally. Restarting securitisation to support lending would be important and could be fostered by government initiatives focussing on standardisation, transparency and due diligence to restore investor confidence. Regulatory reforms currently being proposed concern accounting rules, capital requirements and compensation issues. However, further reforms are required to address such systemic issues as moral hazard created by public support. Measures would include resolution mechanisms for large and systemically important banks as well as appropriately fire-walled business structures for the financial sector. Peer pressure via co-operation in international standard-setting and relevant bodies should help to keep the reform momentum, overcome political impediments to reform and maintain a level playing field.*

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## I. Current outlook and vulnerabilities

***Financial markets have recovered substantially***

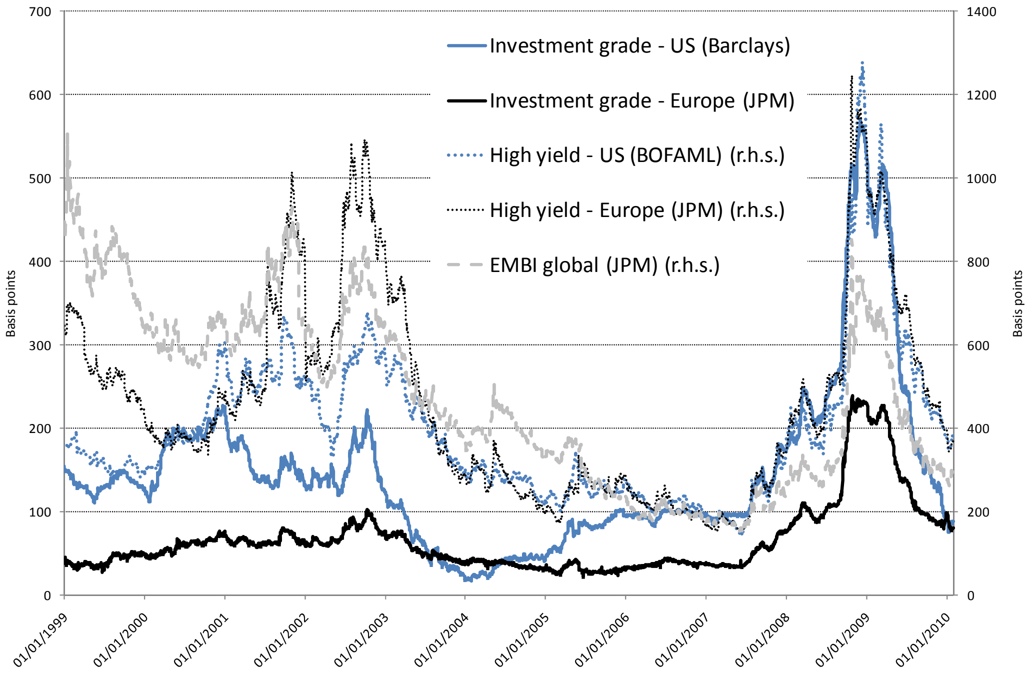
Financial markets have recovered substantially since March 2009 when the financial stress began to ease and market conditions started to improve. With easy monetary policy and large fiscal support to avert larger financial and economic shocks, liquidity and credit risk premiums have narrowed significantly (Figure 1). Market value gains have now, globally, neutralised about 60% of the losses incurred since the onset of the downturn (Figure 2).

***...but vulnerabilities remain significant***

While financial markets have entered a period of relative tranquillity and the outlook for economies has improved,[1] the effects of the financial crisis linger and vulnerabilities remain, as some of the negative feedback loops are working their way back from the real sector (which was affected by a delay bby the first wave of the financial crisis). Should the various risks for the financial sector materialise in the current conjuncture, their impact could be relatively more significant than under more stable circumstances.

Figure 1. **Risk spreads have narrowed**

High-yield and emerging market bond spreads




*Note:* Daily data until 1 February 2010.

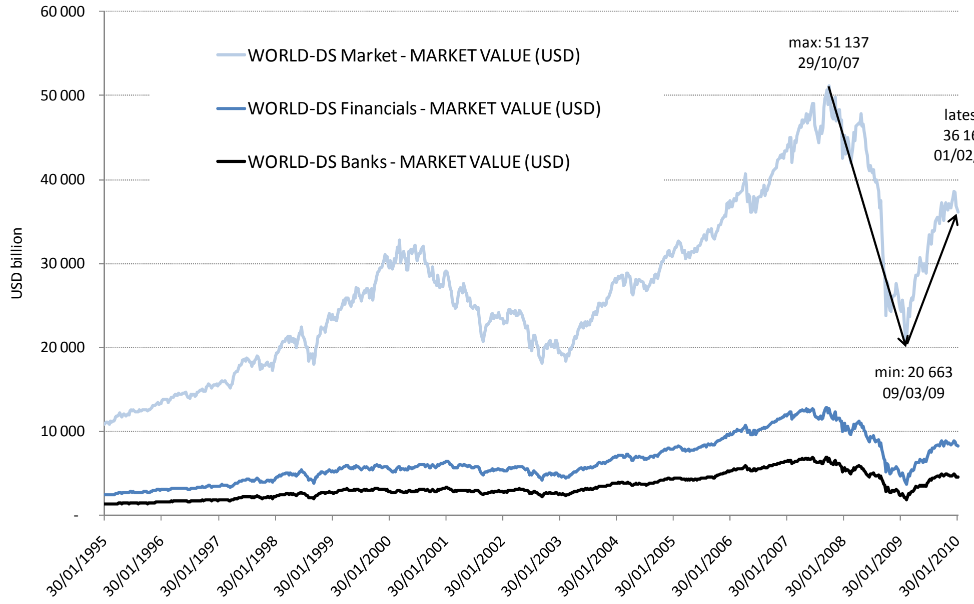
*Source:* Thomson Reuters Datastream.

***New bubbles may be forming***

While easy monetary and fiscal policies have been providing relief from the most severe effects of the crisis, they maintain global liquidity at a high level (Figure 3). As investors' uncertainties and fears subside, this liquidity is searching for new, higher-yielding investments (Figure 4). Upward price pressures on certain asset classes are emerging, and some signs of new bubbles are becoming apparent.

**Figure 2. Equity valuations are recovering**

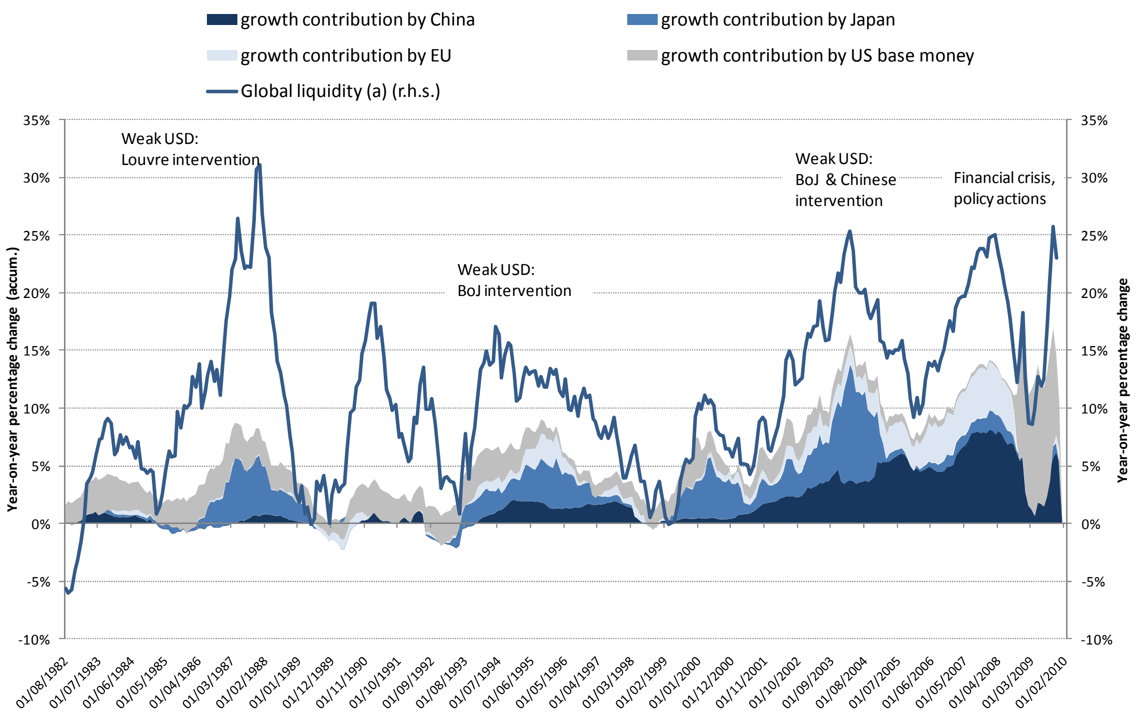
Datastream World indices, market valuations in USD billion




*Note:* Based on equity valuations of constituents contained in the respective Datastream World indices as shown.

*Source:* Thomson Reuters Datastream.

**Figure 3. Global liquidity remains ample**

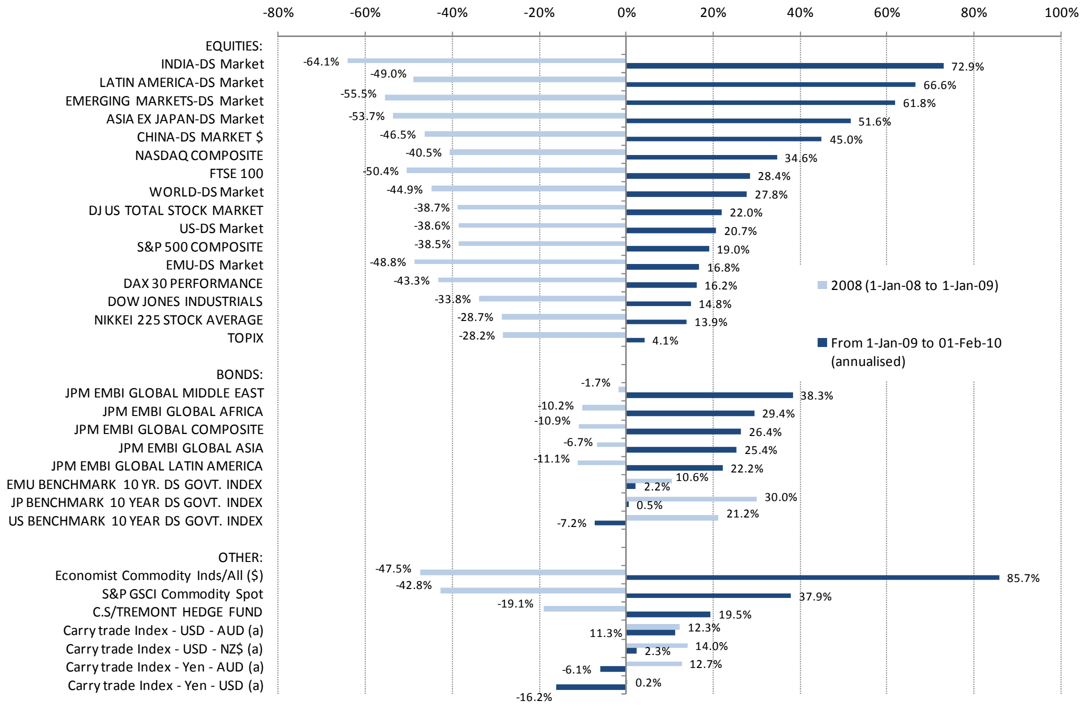



*a)* Annual growth of non-US international reserves and US monetary base.
*Note:* Contributions to growth measured by the respective reserve or monetary components in the liquidity measure.

*Sources:* Thomson Reuters Datastream, and OECD.

**Figure 4. Returns have improved across a broad spectrum of asset classes**

Selected investment alternatives, percentage changes over period, annualised, in US dollar terms




a) The carry trade return index is calculated based on the assumption of one-month investments in the respective currencies, borrowing in yen, applying one-month eurodollar interest rates and central exchange rates, without taking into account bid-ask spreads and transaction costs.

*Sources:* Thomson Reuters Datastream and OECD.

***…in emerging markets in particular***

However, there is some agreement among market observers that despite the rallies in almost all asset classes, most of them have not reached bubble territory. Perhaps the high-yield bond segment, which has seen record levels of issuance in recent months (while declining spreads reflect investors' increasing risk appetite), bears watching. But market participants are becoming wary of some early signs of bubble formation that are beginning to show in Asian and other emerging markets. On-going adjustmentd to the global saving and investment imbalances are rendering many of these economies more vulnerable than investors may currently be aware. While carry trades are becoming profitable against the background of low US interest rates and some fixed Asian exchange rates, the build-up of trades could create problems farther down the road. The rallies in these markets may create the fault lines for future disruptions.

***Real estate markets remain a problem, and credit quality is deteriorating across a broad spectrum of lending categories***

At the same time, house prices (their sharp drop was at the heart of the current crisis and some analysts believe they still need to undergo further downward adjustment) are beginning to rise, too early perhaps, in some parts of the world.[2] Commercial property may turn into a severe problem, especially in Europe where a vast amount of commercial property loans need to be restructured or refinanced, part of it in commercial mortgage-backed securities (CMBS) for which restructuring has proved especially difficult. In addition, credit quality across a broad spectrum of lending categories is further deteriorating, and default rates are expected to rise.

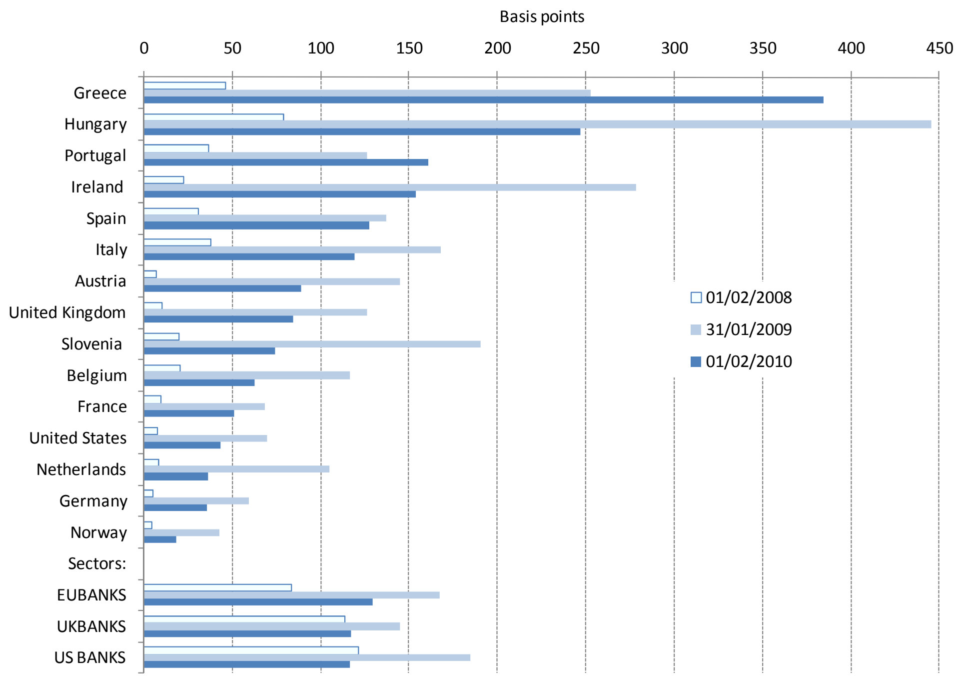
***Recovery in money markets has been uneven, favouring the United States***

Market participants have also pointed out that market recovery has not been even, in part due to unlevel playing fields that risk becoming more unbalanced. In particular, in security-backed short-term cash markets, divergences between the United States (and Asia-Pacific) on the one hand and Europe and the United Kingdom on the other are still significant. In the United States, where markets have benefitted from the Term Asset-Backed Securities Loan Facility (TALF) programme and where underlying securities are more homogenous, markets are more liquid, while in Europe the challenges to access short-term cash are much greater because collateral securities carry more idiosyncratic risks and maturities tend to be longer, exposing them to extension risk.

***Risks also exist with respect to policy exit and sovereign debt***

The necessary withdrawal from extraordinary policy support measures constitutes the basis for another set of risk factors. There is a danger that policy makers exit either too soon or too late. In the first case, stimulus withdrawals could throw the economy back into contracting mode, generating an often feared double-dip recession. In the second case, where withdrawal is too late, fiscal deficits would rise even more and inflation could surge, also because monetising the rising fiscal deficits would meet less political resistance than spending cuts or tax increases. New bubbles would easily build, and these imbalances would unnecessarily postpone adjustment and, in the end, require tighter stabilisation policies that might upset financial markets to a larger extent than an earlier adjustment would have. Some of the risks related to fiscal deficits have been foreshadowed in recent sovereign rating downgrades in Europe and rising credit default swap (CDS) spreads for sovereign debt (Figure 5).

**Figure 5. Selected credit default swap (CDS) spreads**




*Notes:* Senior five-year credit default swap premiums (mid) for sovereign bonds; senior five-year credit default swap premium index (mid) for banking sector.

*Sources:* Thomson Reuters Datastream and OECD.

*Co-ordination and communication of exit policies will be important*

While the risks associated with such timing issues may be large, there are also risks that uncoordinated exit policies may create an uneven playing field across financial sectors and countries. There are further risks that inappropriate communication or lack of credibility of proposed exit policies could create uncertainties which could again destabilise markets. Unexpected policy withdrawals could render a transition to the new regime more difficult for financial institutions, and the sector as a whole.

*Exit from policy stimulus should not be precipitated*

There seems to be a broad consensus in the official as well as the private sector that the recent upswing is not yet fully self-sustained and that policy stimulus is still necessary in many economies. At the current juncture, it seems better to err on the side of avoiding the downside risks, which include deflation and a double-dip recession. In the current cycle, the Reserve Bank of Australia was one of the first central banks to raise interest rates in October 2009 (with two further increases in November and December). Similarly, China tightened credit in early January 2010, and others may follow in due course.

*The success of exit strategies will depend on proper co-ordination, timing and policy communication*

Proper co-ordination between fiscal and monetary policies will be important. Also, given differences in economic stance and exchange rate pressures, the speed of exit will have to differ across economies and will thus need proper international co-ordination in order to avoid imbalances and unlevel playing fields. Timely and clear communication of these policies will be important so as to render policies predictable and credible, and to facilitate the transition to a new policy regime. As this crisis has shown, expectations are important and building confidence will be a prerequisite for a solid recovery.

## II. Assessing the resilience of the banking sector

### *Financial sector soundness*

*Financial institutions have increasingly obtained market financing*

As financial markets recovered, financial institutions have been able to raise capital on equity markets, especially in the United States. Share prices have improved; major G-20 banks have on average recovered about two thirds of their 2008 losses (Table 1). These improvements also reflect profit reports, some of which have become more positive after the heavy 2008 writedowns. Banks are now buying back securitised credit on the secondary market and are benefiting from the reduced spreads. These improvements have allowed several banks to repay state aid, and other financial institutions are considering exiting too.

*The effects of liquidity support are now visible in the growing search for yield and appetite for risk*

Liquidity interventions and terming out of public sector funding replaced private sector funding where there were shortening maturities, and the expansion of collateral has allowed banks to refinance in liquid assets. The money market guarantees in the United States have allowed, both directly and indirectly, about USD 4 trillion of assets to continue to circulate. However, the effects of this liquidity increase can now be seen in the increasing search for yield and appetite for risk. This shows up particularly in the fixed-income market through contraction of spreads in the secondary securitised credit market and in spreads of unsecuritised bank credit. Initially this took place at the highest credit quality, but lower-grade credit soon followed the spread contraction.

**Table 1. Banks' market value losses and gains**

Change in market value of largest G20 banks, in USD billion[a)]

| | 2009[b)] | 2008 | 2007 | 2006 | 2005 | 2004 | *memo:* MV (latest)[e)] | *memo:* recovery[f)] |
|---|---|---|---|---|---|---|---|---|
| United States | 250.6 | - 332.0 | - 290.4 | 173.7 | - 20.0 | 162.2 | 765.3 | 75.5 |
| United Kingdom | 173.5 | - 256.7 | - 72.8 | 109.0 | - 19.1 | 58.2 | 374.6 | 67.6 |
| Italy | 27.9 | - 177.9 | 73.2 | 61.4 | 47.1 | 21.4 | 158.9 | 15.7 |
| France | 86.8 | - 157.6 | - 31.6 | 108.6 | 13.4 | 26.9 | 191.3 | 55.1 |
| China | 101.1 | - 124.3 | 60.1 | 82.3 | - | - | 318.1 | 81.4 |
| Australia | 123.9 | - 110.9 | 43.7 | 38.9 | 18.2 | 19.2 | 247.1 | 111.6 |
| Russian Federation | 68.3 | - 110.1 | 24.7 | 47.1 | 17.9 | 4.7 | 97.6 | 62.1 |
| Japan | - 4.0 | - 107.7 | - 111.8 | - 48.6 | 204.0 | 96.3 | 292.7 | - 3.7 |
| Canada | 93.7 | - 97.4 | 12.2 | 31.1 | 37.2 | 24.7 | 226.3 | 96.2 |
| Brazil | 126.0 | - 86.4 | 59.6 | 38.6 | 29.9 | 12.5 | 224.2 | 145.8 |
| Germany | 22.3 | - 80.0 | - 3.7 | 34.1 | 14.8 | 1.2 | 62.6 | 27.9 |
| Turkey | 52.1 | - 69.1 | 40.9 | - 4.0 | 26.0 | 10.0 | 96.4 | 75.4 |
| South Korea | 33.2 | - 63.8 | - 0.0 | 11.9 | 39.1 | 8.2 | 66.8 | 52.1 |
| India | 41.5 | - 59.3 | 56.5 | 16.7 | 11.6 | 7.9 | 93.9 | 70.0 |
| South Africa | 22.0 | - 22.1 | - 0.3 | 6.8 | 7.7 | 23.5 | 61.7 | 99.5 |
| Indonesia | 23.8 | - 16.2 | 7.6 | 14.1 | - 1.4 | 7.3 | 47.7 | 147.3 |
| Mexico | 7.0 | - 8.9 | 5.6 | 6.6 | 0.8 | 4.7 | 24.1 | 77.9 |
| Argentina | 3.7 | - 4.5 | - 0.4 | 2.7 | 0.6 | 0.6 | 7.1 | 81.3 |
| G-20 country total | 1 253.4 | -1 885.0 | - 126.8 | 730.9 | 427.7 | 489.4 | 3 356.3 | 66.5 |
| *memo item:* Euro area total[c)] | 228.6 | - 789.1 | 81.8 | 379.2 | 105.6 | 143.7 | 746.0 | 29.0 |
| *memo item:* G-7 total[c)] | 650.8 | -1 209.4 | - 424.8 | 469.3 | 277.4 | 390.8 | 2 071.6 | 53.8 |
| *memo item:* Global[d)] | 1 671.5 | -2 784.9 | - 43.6 | 1 140.6 | 505.7 | 695.1 | 4 540.1 | 60.0 |

Sorted by 2008 losses.
a) Based on banks contained in respective countries' Datastream bank indices.
Note that such data are not available for Saudi Arabia.
b) From 1-Jan-09 to 1-Feb-10.
c) Based on banks contained in respective countries' Datastream bank indices.
d) Based on banks in Datastream worldwide bank index.
e) Memo item: Market valuation as of 1-Feb-10.
f) Ratio of change in 2009 (b) over the negative change in 2008, in per cent.

*Sources:* Thomson Reuters and OECD.

***Banks' balance sheets are not yet on a sound footing***

But, overall, the situation for the banking sector remains fragile. Writedowns have continued and have not yet been fully matched by private capital raised. While the situation seems to look relatively better for European than for US banks, off-balance-sheet items and contingent liabilities may yet pose serious problems for European banks. Furthermore, the European group of banks reporting losses has a much higher leverage ratio than their US counterparts.[3]

***Future bank losses are still expected to be significant***

Due to accounting requirements,[4] US banks will need to bring USD 1.3 trillion in off-balance-sheet vehicles onto their balance sheets over the next year. Future losses are still expected to be significant. The IMF expects losses of USD 3.4 trillion over 2007-2010, down from the previous USD 4 trillion;[5] JPMorgan has recently published a smaller loss estimate of USD 2.3 trillion.

***Balance sheets are not comparable globally due to***

A note of caution is required when comparing losses and writedown data internationally. Differences in accounting rules make for gaps in the range of perhaps a factor of two. Thus, if such a factor were applied, *i.e.*, assuming

***different accounting rules – a case that presses for harmonisation***

European banks were to apply the US Generally Accepted Accounting Principles (GAAP) instead of International Financial Reporting Standards (IFRS), the recent IMF estimates for losses of European banks could be roughly halved. Nevertheless, losses would remain huge, but such calculations are a stark reminder of the importance of harmonising accounting rules, in particular as international policy co-ordination is of the essence to resolve the crisis.

***Further official support will be needed for the banking sector***

Further official support will be needed as there is not yet enough capital in the banking system, and many banks do not yet have access to wholesale funding. The market is not yet deep enough for the liquidity schemes, put in place in response to the crisis, to be removed. A sudden withdrawal of these schemes would seriously impede recovery. Also, the success of various government programmes to deal with toxic assets (*e.g.*, Public-Private Investment Program for Legacy Assets (PPIP) in the United States, "bad banks" in the United Kingdom, Ireland and Germany) and their phasing out will be crucial for the financial sector to recover.

***Banks are exposed to risks in commercial real estate and business loans***

One of the major risks going forward is in the commercial real estate segment where prices are declining and delinquency rates are rising. In the United States, about 12% of the approximately 8 200 banks have a commercial real estate exposure of more than five times their tier-one capital, and it is estimated that up to a thousand banks will face major difficulties. A second area of banking sector worries is loans to business, in particular large syndicated loans. By end-2009, 118 US banks had failed, and the number is expected to rise substantially.[6]

***Bank lending has not yet picked up as banks are increasing liquidity buffers***

These pending risks and the banking sector's fragility from previous losses are the reason that much of the liquidity support is currently resting in deposits by banks that need to improve their balance sheets. At end-2009, US banks held more than USD 1 trillion in excess reserves with the Federal Reserve. But these reserves not only serve as buffers against expected losses but also act as buffers for the unsecured parts of the interbank market. Banks claim that these reserves are also serving the function to prepare for potentially tighter regulatory requirements. In fact, due to such requirements, the industry expects banking to become less profitable: some observers from within the banking industry expect that return on equity could drop by one third to one half, based on a five-year average measured from 2002 to 2007.

***…but demand factors also play a role***

But lower lending is also due to demand-side factors. Demand-side effects are relatively strong in countries with low saving rates. In the United States and United Kingdom, as well as some other continental European countries where households have to repair their balance sheets, credit demand has been slowing significantly.

***As part of an exit strategy, reserves could eventually be replaced by government bonds***

While the liquidity "hoarded" by banks fulfils useful buffer functions, going forward, and as part of an exit strategy, some industry representatives have proposed that banks could substitute these buffers with government bonds in synch with the withdrawal of liquidity, and in accordance with the expected higher liquidity and capital requirements. Given the future financing needs of governments, there should be no shortage of such bonds.[7]

***Measures to re-establish lending and securitisation markets***

***The key missing link to restart lending is securitisation, which needs to be restored***

One of the key missing links to put bank liquidity to use for lending is securitisation.[8] In the US market, about USD 1.8 trillion (net amount of residential mortgage-backed securities (RMBS) issued by the banking sector in 2007[9]) of securitised assets need to be replaced. The decline in securitisation has left a gap that cannot be easily filled by traditional bank balance sheet lending alone. Securitisation is a way by which private investors fund household and business loans and is thus an important element in restoring economic growth. The two publicly distributed asset-backed securities (ABS) deals in Europe in late summer 2009, the first since July 2007, were seen by many market participants as an indication of the right way forward. It is thus in the interest of policy makers to help restore this market segment, and the current central bank lending programmes (widening of eligible collateral) are part of these efforts. It is noteworthy that the ECB's collateral framework had allowed the use of ABS as eligible instruments, even before the sudden appearance of the funding difficulties, which proved great support during the crisis.[10] As some central banks have become large securities buyers, policy makers need to think about how to make these markets sustainable once official demand is withdrawn. More structural measures will need to be put in place to support the market.

***...with policy support that focuses on standardisation, transparency and due diligence***

Policy makers have many possibilities to support securitisation markets and to restore investor confidence and secondary market liquidity, *e.g.*, by enhancing standards, transparency (such as allowing access to loan-level data, already possible in the United States) and overview of investor due diligence. Institutional investors are currently avoiding these markets because many of them have lost confidence. And, due to single-name limits, many of the institutional investors would also not be allowed to invest large volumes directly in a few large banks (those that were the main RMBS issuers). As many of these investors were forced to sell the toxic assets, they took the brunt of the price adjustment, while banks are now buying (back) many of the securities on the secondary market (while at the same time they are hardly issuing any new ones).

***Loan funds could support lending***

Further proposals for official measures to re-establish lending and securitisation markets could be put forward. One is that government compete with banks through asset management companies that would extend direct loans to the industry. Some so-called loan funds engaging in this type of business exist already.

***Measures need to be initiated by government***

Deriving lessons from the origins of the development of securities and derivatives markets could help. The securitisation model's original purpose (in the late 1980s) was transferring risk to investors who previously had unsecured (not asset-backed) exposure, and it had evolved into a well-established system with standards, enhanced infrastructures and built-in checks and balances. Likewise, swap markets developed through standardisation, netting agreements, *etc*. Thus, the securities market would also benefit from standardisation of products, better information, transparency and due diligence. Policy makers would need to provide the momentum (as was done in the case of the creation of swap markets) to develop these measures. For example, the Eurosystem has taken some steps to simplify the structures of ABS, which it accepts as collateral in order to create more transparent instruments.[11] Such transparency, with more timely and standardised information on the performance of underlying loans, would help investors' due diligence.

*Exchange trading would enhance price transparency and attract more investors*

Better price transparency is one of the elements needed to make the market more liquid. This could be achieved by transferring a large part of the business away from over-the-counter (OTC) trading onto exchanges, where government could initiate or support market-making activities if needed. Furthermore, the traditional buyers of securities credit used to be short-term, fixed-income and cash investors because of the floating-rate nature of these products. Turning them into more fixed-rate-like products could attract a different buyer base into the market.

### *Voluntary exit from government support by financial institutions*

*Some banks have started to pay back public support*

So far, a decline in borrowing from the various emergency liquidity facilities provided by central banks in response to the crisis has been observed, and banks have made efforts to pay back the government support they received in response to the crisis. US banks (large money centre banks) had by end-2009 paid back about USD 164 billion of public support[12] and raised capital beyond that amount. Similar paybacks have taken place in France (where all banks have reimbursed official money), the United Kingdom and elsewhere,[13] and many banks are considering such exit from state support.

*…but such exit has to be carefully managed*

But such exits have to be carefully designed and managed. While the improvements in financial markets have made it relatively easy for banks to repay state aid, an exit from government support may be premature for many institutions and not warranted with the still fragile situation. But, again, many government programmes were designed in such a way as to make state aid unattractive as market conditions improve. Some of these built-in withdrawal incentives may have to be reassessed as aid programmes are being rescheduled. Perhaps governments should also establish conditions under which a recipient institution would be allowed to repay government support. Such rules would then need to be communicated in a proper and timely manner.

*Market-driven exits should not create undue risk*

More generally, exit from state support should happen without creating undue risk. For example, reimbursement of official funds could happen under the conditions that *i)* paybacks are replaced by high-quality capital raised; *ii)* assets, especially risky assets, on the balance sheets of banks concerned are fairly valued; and *iii)* these banks have a viable long-term business strategy. To qualify for repayment of state aid, institutions should also credibly demonstrate to have market access and should be able to raise capital by issuing equity, and not by excessive deleveraging and tightening credit supply. Such conditions could also specify that capital ratios should remain comfortably above the regulatory minimum. Quality requirements for private capital that is used to replace public capital support could specify, *e.g.*, that private capital should be at least of the same quality as the public capital that is being repaid.

## III. Some issues for further regulatory reform

### *Governments' enhanced role and moral hazard problems*

***Public support creates moral hazard***

Public sector support for the financial sector during this crisis has been exceptional, ranging from capital injections, asset purchases and various forms of central bank support to guarantees. Guarantees constitute by far the most extensive support category, even though in principle no upfront financing is needed and the contingent liabilities may remain undrawn.[14] While this support has so far been successful in averting an even bigger financial crisis, there is broad agreement between policy makers and the private sector that direct involvement of governments in markets should not be extended over the long term. Such involvement sustains or even fosters moral hazard, as risky behaviour is favoured. In particular large, "too-big-to-fail" institutions benefit from large-scale financial support, and negative consequences of imprudent lending or other high-risk activities are not properly sanctioned. Risk is underpriced.

***...and at times uncertainty, and it distorts competition***

At the same time, a discretionary element in such support may lead to uncertainty that affects planning and creates inefficiencies in the financial sector (the financial market calamities after the Lehman default serve as a telling example of the effects of such uncertainty). Furthermore, uneven support creates an unlevel playing field (with smaller institutions at the lower end). The on-going and selective official intervention in mainly large financial institutions during this crisis has the potential to distort competition to the detriment of smaller and perhaps more viable banks, running the risk of "subsidising failure" and creating moral hazard. Expectations of future bailout in case of failure may also be a problem for (uninformed retail) investors who have the, perhaps wrong, perception of a risk-free trade in dealing with such banks.

***Withdrawals should be properly managed***

However, it is clear that certain elements of the safety net provided by governments and central banks will have to remain in place to safeguard financial stability (*e.g.*, deposit guarantees to avoid bank runs), but other elements need to be withdrawn in order not to prolong and foster the negative effects mentioned above (moral hazard, distortion of competition, *etc*.). The crucial issue to be addressed is then how to obtain the benefits created by financial system stability while minimising the downside risks and losses for taxpayers.

### *Accounting rules and capital standards*

***Single global accounting standards help minimise distortions and regulatory arbitrage***

With regard to accounting rules, where different rules and standards can create significant distortions, co-ordination is particularly relevant. For example, leverage ratios are defined differently under US GAAP and the International Accounting Standards (IAS) as applied in Europe and elsewhere. Some observers also see problems arising from recent regulatory initiatives regarding trading book rules. There are proposals that capital requirements should be increased for any illiquid asset in the trading book. But illiquid assets should not be in the trading book at all. That is due only to accounting rules that allow classifying even illiquid assets as available for sale, without regard to the actual time it would take to sell the asset in question. If accounting rules allow defining the holding period of assets over almost any time span, they create distortions between liquid and illiquid assets. Thus, treatment of these assets is another area that needs global standards.

***Trading book rules need to be well balanced***

However, the banking industry has pointed out that, given the importance of trading activities for secondary market liquidity and capital market intermediation more generally, trading book rules should be addressed by regulators in a balanced way – as is the case for banking book rules that balance the need for prudential requirements and the need to extend credit to the economy. Some of the current proposals are seen as imposing "onerous" liquidity and capital requirements on trading books.

***Capital requirements also need common global standards; leverage ratios need a risk-based complement***

Capital requirements are another area where common standards are needed, as there is a danger that in implementing standards, countries move at a different pace and towards different definitions, which could create major distortions. Regulators and industry representatives agree that capital requirements should move towards higher quality and more self-sufficiency. Many see the currently discussed leverage ratio requirements as useful, but there are some fears that if introduced without risk-based capital requirements they would create distortions with respect to firms' financial buffers. Because of its simplicity, Basel I is often seen as having driven much bank lending activity off their balance sheets and as having created a lot of regulatory arbitrage. Given the complexity of the banking business, many see simple capital rules as insufficient.

***Higher liquidity and capital provisions will make the industry less profitable***

As higher liquidity and capital provisions will make the industry less profitable, the question is also what rate of return do institutional investors expect from bank equity. If investors continue to expect high returns, this could put banks under pressure to engage in more risky business.

### *Compensation issues*

***Remuneration schemes need to be risk compatible***

There is broad agreement between the industry and policy makers that there is a need for better, risk-compatible remuneration schemes in order to avoid excessive risk-taking. This is particularly relevant for big banks and financial conglomerates where risk-reward schemes are largely distorted by cheap funding paired with moral hazard.

***Recommended remuneration standards are being implemented, but performance targets need to be lowered***

Remuneration systems at many banks are being brought in line with recommended standards,[15] taking into account risk-compatibility and longer-term goals. But these measures will become truly effective only if they are implemented uniformly (given the mobility of the financial labour force) and if performance targets, which are still too high in many cases, are lowered accordingly. Perhaps bonus payments should not be linked to *beta* (the general market) but to the *alpha* effect (manager-specific performance). In banks, the risk-return relationship in remuneration tends to be distorted, as traders are risking "other people's money" with little personal downside risk (unlike, for example, hedge fund managers who often have personal money at stake).

*Risk management has improved*

In response to the crisis and in line with recommendations, risk management in most institutions has been improved by instilling a better risk culture in banks and their boards. For example, in many banks the role of the chief risk officer is being enhanced, as is the risk function performed by the CEO in defining and examining the risk profile of the institution.

*But even risk-compatible remuneration policies cannot spare firms difficulties*

It should be also be noted, however, that compensation policies are not a panacea. Remuneration policies of some institutions had already been aligned with the long-term interests of the firm, yet this did not help them much in avoiding a crisis. Notably Bear Stearns had paid its bonuses in shares with a vesting period of five years, one of the longest terms in the industry. Moreover, at the time the firm went bankrupt, Bear Sterns employees owned about one third of the firm, with senior executives – whose decisions were crucial for the performance and survival of the firm – having the largest share. Many financial sector employees lost out in the current crisis. Going forward, many banks will probably reduce the bonus part of employee compensation, thereby reducing risk-taking.

*Officials in regulatory and supervisory authorities may need to be better paid and closer to the market*

The current crisis has revealed failures not only in the financial industry but also in the regulatory and supervisory system. To attract a capable – and, moreover, globally mobile – workforce required to deal with ever more complex issues and to increase the quality of supervision, it has been suggested that the compensation of officials in regulatory and supervisory authorities needs to increase. Furthermore, market experience should be required of these officials, which should give them the insight and working knowledge required for due diligence exercises.

### *Systemic considerations, bank structure and resolution mechanisms*

*Systemic relevance needs to be defined in a dynamic way*

Systemic relevance is defined by the size and/or interconnectedness of an institution, but clear measures and definitions are lacking. The Financial Stability Board (FSB), in which the OECD participates, is currently looking into these issues, including definitions of systemic importance.[16] But again, defining and then permitting the existence of "systemic" banks may create more moral hazard and competitive distortions if not counterbalanced by, for example, greater capital requirements. Perhaps a combination of effective micro- and macro-prudential supervision allowing a dynamic identification of the problem is needed.

*Structural firewalls within financial firms could reduce systemic risk*

An additional approach is to devise principles and structures that would avoid financial institutions becoming too large and systemically important, *i.e.*, avoid maintaining or creating too-big-to-fail institutions. The recent US initiative to separate banking business tries to address such problems.[17] Another proposal would envisage putting firewalls in large financial conglomerates, via a non-operating holding company (NOHC) structure.[18] Such a structure would enhance transparency (financial reporting for each entity), improve governance, level the playing field (group affiliates compete with stand-alone companies), allow separate resolution of affiliates and ease regulatory intervention. Such reforms would be essential to deal with the contagion and counterparty failure that have been the main hallmarks of the current crisis. This approach would also be somewhat more flexible than a stricter separation of banking business like the one under the Glass-Steagall Act.[19]

*…and could make resolutions of large banks that are very complex easier*

As past developments in the financial industry have shown, imposing one single business model would not be helpful, given the growing complexity and interconnectedness of financial markets and products. A firewalled NOHC structure could help to solve the complex issues that arise related to the resolution of large banks. Various advances with regard to resolution procedures have been made, and additional reforms are underway, like the Special Resolution Regime (SRR) in the United Kingdom (UK Banking Act 2009). But resolution issues also involve, for example, differences in the data architecture, and arise from the fact that legal and business forms do not overlap, but are intertwined in a complex matrix that makes resolutions, even of only single entities of the whole structure, complicated.

*"Living wills" for systemic firms may be very costly*

A so-called "living will" approach has been proposed under which (systemically important) financial companies (banks in the current UK proposal) would have to devise detailed plans that would enable them to stipulate in advance how they would raise funds in a crisis and how their operations could be dismantled after a collapse. Such plans could also improve cross-border litigation and help to mitigate uncertainties and avoid panic reactions to the failure of a major, globally active financial institution. But implementing such living wills may involve heavy reporting requirements with the need to provide constantly updated information, in line with an evolving business structure, and may thus prove to be unduly costly. The current complexity of the banking industry would make such an exercise very difficult.

### *Some current regulatory reform proposals*

*OECD proposes a Policy Framework for Effective and Efficient Financial Regulation*

The OECD has recently proposed a Policy Framework for Effective and Efficient Financial Regulation.[20] The Framework is a tool that can support ongoing efforts by policymakers, regulators and supervisors to achieve a stronger, more resilient financial system. As it is general in nature, it cannot be a substitute for more focused, micro-prudential principles and guidelines of international standard-setting bodies. But it can guide strategic thinking and promote governmental leadership and action so that the financial system can play its vital role in the functioning of the economy, both domestically and globally. While future crises can hardly be avoided, regulation and supervision in a "new financial landscape" should be based on guiding principles that allow striking the right balance between stability and growth, in supporting and maintaining financial sector resilience without stifling financial innovation.

*G-20 as a platform for regulatory reform discussion*

Recently, the G-20 has become a platform to discuss and help co-ordinate not only current financial sector support but also further regulatory reform in the financial sector. In their September 2009 Statement, G-20 finance ministers and central bank governors emphasised, among many other necessary reforms, the need for revised accounting standards, new liquidity and capital requirements, as well as stronger oversight and better resolution procedures.[21] Most of the technical work is currently being undertaken by the FSB and its related bodies. Comprehensive consultative proposals to strengthen the resilience of the banking sector and to create an international framework for liquidity risk measurement, standards and monitoring have recently been put forward by the Basel Committee on Banking Supervision.[22]

***The financial industry proposes reforms and seeks co-operation***

The financial industry responded to the crisis early on with its own initiatives for self-regulation.[23] Co-ordination and communication efforts have been stepped up not only between policy makers, but also between the government and the private sectors. As the shape of a future financial landscape is not yet well defined, and with different and often country-specific support measures in place, there is a risk that new regulations are being introduced in an uncoordinated fashion. Regulatory impact studies involving all stakeholders would be an important complement to new regulatory measures.

***Peer pressure is important as political momentum for reform may wane***

Co-ordination in the design of a new financial landscape remains important. There is a danger that the political momentum for financial reform may soon lose steam as an improving economic situation appears to obviate the need for more substantive reforms. If political pressures leading to impediments in reform efforts are building up unevenly across countries, regulatory arbitrage may become a problem. International co-ordination, including peer pressure exerted through international (standard-setting and other) bodies, should help to keep the momentum for reforms.

# NOTES

[1] OECD (2009b).

[2] In the United States, the Case-Shiller house price index changed direction in May 2009, growing 3% in the second quarter, the first quarterly increase since 2006q2. However, official statistics (from the Federal Housing Finance Agency - FHFA) still show a decline (in their latest values as of 2009q3).

[3] Blundell-Wignall *et al.* (2009a, b).

[4] FASB's new rules FAS 166 and 167, which concern the accounting of securitisations and special-purpose entities, are scheduled to become effective at the start of a company's first fiscal year beginning 15 November 2009, or 1 January 2010 for companies reporting earnings on a calendar-year basis.

[5] IMF (2009).

[6] Research from CreditSights suggests that 600 to 1 100 of America's 8 200 banks may need help from, or winding down by, the Federal Deposit Insurance Corporation during this cycle.

[7] Government borrowing needs are expected to surge: gross borrowing needs of OECD governments are expected to reach almost USD 16 trillion in 2009, up from an earlier estimate of around USD 12 trillion, and again around USD 16 trillion in 2010; see Blommestein and Gok (2009) in this issue of *Financial Market Trends*.

[8] In this context, see also Lumpkin (2009) in this issue of *Financial Market Trends* for a more general discussion of financial innovation.

[9] Fed data (gross figures) show that home mortgage debt in RMBS pools amounted to USD 2 168.61 billion at the end of 2007 and USD 1 848.02 billion end-2008.

[10] González-Páramo (2009).

[11] González-Páramo (2009).

[12] U.S. Treasury Department press release of 23 December 2009: "Treasury receives $45 billion in repayments from Wells Fargo and Citigroup – TARP repayments now total $164 billion". See also SIGTARP's reports to Congress, available at www.sigtarp.gov/reports.shtml.

[13] Even the troubled, state-owned German Hypo Real Estate bank reimbursed, in December 2009, EUR 7 billion of the initial EUR 50 billion rescue package provided in 2008 by a consortium that included the federal government, the central bank and private institutions. The total amount of guarantees still at HRE's disposition fell from EUR 102 billion to EUR 95 billion.

[14] Schich (2009b) in this issue of *Financial Market Trends.*

[15] The industry itself has made proposals that are largely in line with official proposals by the FSB and other bodies. Generally, these recommendations suggest that employee remuneration should be in line with the employing institution's long-term goals and should not induce excessive risk-taking. Thus, upfront multi-year bonuses, for example, would not be in line with these recommendations. See IIF (2008).

[16] See IMF-BIS-FSB (2009).

[17] See also the OECD statement "US: Obama plan for banks can help to avoid a new financial crisis" at www.oecd.org/document/55/0,3343,en_2649_34487_44475383_1_1_1_1,00.html.

[18] For more details, see Blundell-Wignall *et al.* (2009b), in this issue of *Financial Market Trends*, and OECD (2009a).

[19] The Glass-Steagall Act, devised during the Great Depression, separated investment banking from commercial banking, prohibiting a bank holding company from owning other financial companies and prohibiting a bank from offering investment banking and insurance services. This separation had already been abandoned, and the "pure" investment banking model softened in 1999 when the Glass-Steagall Act was repealed by the Gramm-Leach-Bliley Act, which allowed commercial and investment banks to consolidate. This made permanent a temporary waiver that was issued for Citibank's merger with the insurance company Travelers Group in 1993 (finalised in 1994; in 1998 they formed the financial conglomerate Citigroup).

[20] See OECD (2009c) in this issue of *Financial Market Trends*.

[21] See www.g20.org and Box 1 in Blundell-Wignall *et al.* (2009b), in this issue of *Financial Market Trends*.

[22] See Basel Committee (2009a, b), announced on 17 December 2009 at www.bis.org/press/p091217.htm. The reform programme has been endorsed by the Financial Stability Board and by the G-20 leaders at their Pittsburgh Summit, and comments on the consultative documents are invited by 16 April 2010.

[23] For example, IIF (2009).

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