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Containment and Cure: Some Perspectives on the Current Crisis

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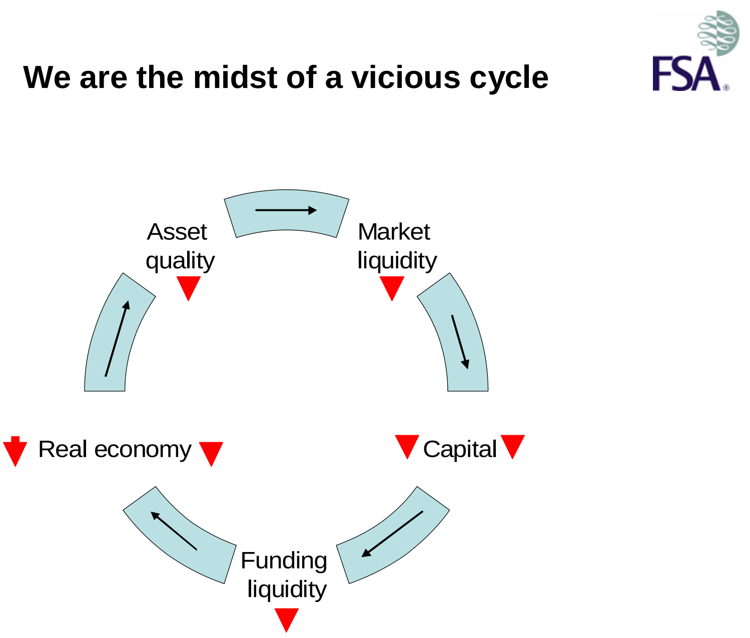
Containment and Cure:
Some Perspectives on the Current Crisis

Thomas F. Huertas[*]

Today we are in the midst of a financial crisis. That crisis may lead to a severe recession.

Two questions confront us all. How do we contain this crisis, and how do we cure the system, so that crises will not recur in the future?

Containment must be our first priority. We must arrest the downward spiral in finance in order to avoid the devastation of the real economy that would be caused, if the financial system ceased to function effectively.



Today we are caught in a vicious circle. Asset values have been declining for well over a year. Market liquidity is evaporating. Bid-ask spreads are widening, and for many complex assets there are no bids at all. The decline in asset values has imposed losses on firms and shrunk banks' capital. That in turn has raised concerns about the credit-worthiness of the banks. This in turn has created pressures on funding liquidity. To conserve cash banks are cutting back on credit availability and this is adversely affecting the real economy. The world now faces the prospect of a severe recession.

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Failures of financial institutions, and the manner in which those failures were dealt with, further aggravated the situation. In particular, the failure of Lehman Brothers in September reversed expectations created by the earlier rescue of Bear Stearns that large broker dealers would not be allowed to fail. Moreover, the failure of Lehman Brothers brought home to all that global institutions may be global as going concerns but they become a series of local legal entities when they become subject to administration and/or liquidation. The failure of Lehmans caused market participants to review quickly their securities lending arrangements, limit rehypothecation and reallocate free cash balances. That had very significant knock-on effects on other broker dealers.

The failure of Washington Mutual, also in September, compounded these effects. The US authorities failed to keep whole the senior debt holders in the bank. This contrasted markedly with their behaviour in resolving other bank failures. This change in resolution practice caused market participants to revise their estimates of risk in senior, unsecured obligations of banks, further aggravating the funding squeeze.

Other bank failures compounded the problem, including Bradford and Bingley here in the UK, Fortis in Belgium/Netherlands, HRE in Germany, and the collapse of much of the Icelandic banking system. So did the extended debate in the United States about whether and how to enact the $700 billion TARP programme as well as the growing realisation that, even it were enacted, it would take time to implement.

To combat this crisis, authorities are taking steps to assure that banks are sound, so that they can continue to fulfil their prime function of intermediating credit – taking deposits and making loans. That entails assuring that banks have adequate capital and adequate liquidity as well as designing programmes to extract the toxic assets from banks' balance sheets.

Against this backdrop of deepening crisis, the UK Tripartite Authorities announced on 8 October that they would implement a comprehensive £500 billion plan to support the UK banking system. The plan addressed both capital and funding liquidity together, not one in isolation from the other. The plan:

- Doubled the size of the Bank of England's Special Liquidity Scheme to £200 billion;

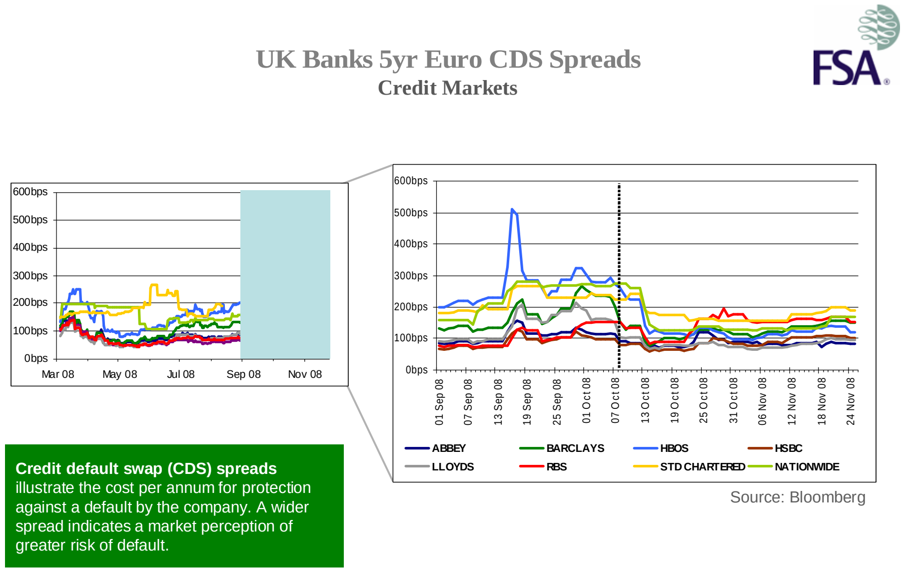
- Instituted a guarantee programme (the Credit Guarantee Scheme) of approximately £250 billion for new wholesale debt issuance by banks that either already have or have a plan for raising Tier 1 capital in the amount and in the form the Government considers appropriate;

- Indicated that the Government had allocated £50 billion to act, if need be, as an underwriter or capital provider of last resort (the Bank Recapitalisation Fund) to enable banks to meet the capital standard required for participation in the Credit Guarantee Scheme. For institutions that availed themselves of the Government's offer to subscribe to new capital, the Government imposed additional institution-specific conditions relating to dividends, executive compensation, board representation, management and strategy (including commitments with respect to lending to individuals and SMEs in the UK).

The combination of higher capital and credit guarantees is designed to limit the risks to the taxpayer.

The prompt translation of the plan into action initially had a calming effect on markets, particularly since other countries such as France, Germany, the Netherlands, Switzerland and the United States quickly followed with the implementation of similar measures. All in all, governments around the world have pledged well over €5 trillion in credit guarantees and capital injections for the world's major banks.

Initially, these actions appeared to stabilise the situation. CDS spreads narrowed, LIBOR rates dropped, and liquidity began to return.



Then, the United States reversed course. Initially, the Troubled Asset Relief Programme (TARP) envisioned that the Treasury would buy troubled or toxic assets directly from the banks. Then, in mid November the Treasury announced that it no longer intended to do so. This caused a dramatic further decline in the prices of troubled assets, leading to further losses and to pressures on banks, such as Citigroup, that had significant amounts of such assets. On 23 November the US authorities announced that they has put in place a further recapitalisation of Citigroup along with an arrangement to guarantee over $300 billion of Citigroup's assets in exchange for further warrants on Citigroup common stock as well as restrictions on Citigroup's paying dividends and bonuses to senior executives. This structure paralleled an earlier transaction that the Swiss National Bank had conducted with UBS.

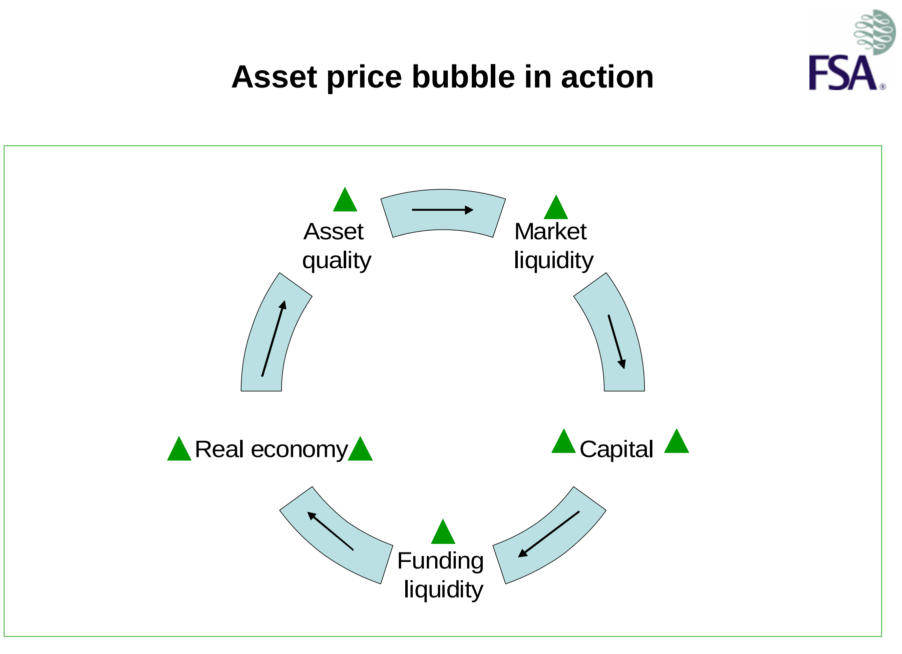
In addition to the measures taken to stabilise individual banks, central banks have taken supplemental measures to improve liquidity through direct asset purchase programmes as well as through expanding the range of eligible collateral. In the

United States the Federal Reserve has purchased directly maturing commercial paper as well as Fannie Mac and Freddie Mac mortgage securities. In the UK the Bank of England has revised its Red Book to expand the range of eligible collateral and to reduce the pricing for its Standing Facilities.

Central banks and governments are supplementing these institution and market specific measures with massive macroeconomic stimulus. Central banks have slashed interest rates. The Federal Reserve has reduced the Fed funds rate to 1%. The Bank of England reduced its base rate by 150 basis points to 3% and reduced it again on 4 December to 2%. The ECB has reduced rates once and did so again on 4 December. Governments have announced massive fiscal stimulus packages combining tax cuts and spending increases.

Even as we grapple with the problem of how to contain the current crisis, attention is turning to the question of how we can prevent the system from again going awry. The expanded G-20 has met in Washington and delivered a comprehensive set of recommendations. The EU has established a Committee of Wise Men under the chairmanship of Jacques de Larosiere to consider appropriate reforms to the EU structures.

These summit initiatives come on top of legislative and regulatory proposals that are already under consideration at national and EU level. This evening's speech is not the time to go into great detail, but a few elements are perhaps worth bearing in mind as these discussions intensify.



First and foremost, our attention must be on the measures that can moderate the cycle that runs in good times from increasing asset prices to greater market liquidity to higher profits and higher capital, to greater funding liquidity and to increased real economic activity. Essentially we are talking about measures that will prevent asset price bubbles from forming in the first place.

And that will be difficult, not least because people are generally delighted as an asset bubble inflates. Rising house prices, rising stock prices and rising bond prices are all perceived to the good things. And so they are, provided they do not rise too rapidly and sow the seeds of a crash to come.

Let me start with measures that pertain to asset prices and market liquidity. The current crisis has its origins in the evaporation of market liquidity in complex, difficult-to-value assets, so-called Level 3 assets, which are subject to "independent price verification". Recently, the IASB has changed its rules so that firms reporting under IFRS can shift such assets from the trading book to the banking book, if they intend to hold the assets to maturity. This brings IFRS into conformity with US GAAP and should facilitate resolution of the crisis.

But this accounting change only addresses the symptoms of the problem. The more fundamental issue is the investment banking business model. Is this sustainable? Should it be preserved?

The investment banking model is frequently described as "originate to distribute". It was anything but. The most significant problems over the past year have been associated with banks that originated but did not distribute. For example, some banks thought that it paid to keep vast quantities of super senior tranches of securitisation deals on their own books – quantities that amounted to several decades of daily trading volume in such securities. Those sure-fire super senior tranches become the financial equivalent of hula hoops piled up in the warehouse of a defunct retailer. Other banks thought it was wise to warehouse extensive amounts of mortgages, pending securitisation, so that they could save on underwriting fees. Such banks effectively took massive amounts of liquidity risk. They simply did not distribute quickly enough. Effectively, these banks were taking inventory risk – and they either ran out of funding or they found that investors did not share their assumptions about the value of the merchandise that they had elected to stockpile.

Other banks thought is made sense to arbitrage risks – to invest in complex illiquid securities through conduits or structured investment vehicles that they created and managed and to whom they supplied explicit or implicit liquidity support. This liquidity support enabled the conduits and SIVs to fund themselves in the commercial paper market until such time as the prices of the complex illiquid securities began to crumble. Then the banks had to take a good portion of the assets back onto their balance sheets and to bear the losses. So the distribution that banks made to conduits and SIVs was the worst kind of distribution – reversible distribution.

To prevent such excesses from happening again, three measures are under consideration. The first is a requirement to force banks to consolidate conduits, SIVs and other so-called off-balance sheet vehicles into their reported accounts and to keep capital and liquidity against the risk that such vehicles create. The second is to introduce dynamic provisioning. Spain has used this effectively to require its banks to build up loan loss reserves in good times so that they could be drawn upon when the economy turned down.

The third, and most controversial measure, is to impose a leverage restriction on banks in addition to the risk-based capital requirement imposed under Basel 2. Proponents frequently note that the US has employed a leverage ratio for a number of years. However, the leverage ratio employed in the US did not prevent firms from suffering very large losses on large concentrations of sub-prime assets. Nor did the leverage ratio prevent firms from sponsoring SIVs and conduits – vehicles that ultimately contributed to severe liquidity pressures. Nor did the leverage ratio prevent problems from arising at Citigroup, Wachovia or Washington Mutual. So if we are to adopt a leverage ratio as a countercyclical device, we should certainly not adopt the US version as is.

In designing and implementing any type of leverage ratio, we will confront two boundary problems: which activities within a group should be subject to the ratio, and which firms should be subject to the ratio. The Swiss, for example, are suggesting that the domestic Swiss retail banking activities should be exempt from the ratio, whilst the international, investment banking activities of the group should be subject to the ratio. Experience has shown, however, that firms are quite adroit at arbitraging differences in requirements across different books within the same group. Indeed, some of the current crisis can, in my view, be traced to firms' placing assets that did not trade and were not liquid, such as super senior tranches of CDOs, into trading books, so as to benefit from lower initial capital requirements. So, if leverage ratios are to be employed, consideration should be given to applying them to the group as a whole.

The second boundary problem is more difficult. How do we decide which entities should be subject to the leverage ratio? Should this be restricted to entities that take retail deposits on the theory that society provides a safety net in the form of deposit insurance to protect the depositor? Or should the leverage ratio apply to any firm or group that would have access to liquidity facilities from the central bank? Or should the leverage ratio apply to any entity, including hedge funds and possibly non-financial corporations, whose failure could disrupt financial markets?

Subjecting one type of firm to leverage ratios whilst others are exempt is an open invitation for business during the boom to flow to the unconstrained sector. Indeed, one could imagine that stringent leverage ratios on financial intermediaries could further promote direct capital markets issuance by frequent issuers. If business does flow out of the constrained sector, will the constrained sector have the opportunity to build up the capital and reserves necessary to be able to provide credit to the economy as the boom turns to bust, and margins increase? For leverage ratios to be effective as a means of tempering macroeconomic booms and busts, will it be necessary to impose such ratios not just on the intermediaries, but on borrowers themselves? Or is the wiser course of action simply to drop consideration of the leverage ratio?

Capital is the next element of the cycle, and this will certainly get extensive attention from regulators and policymakers. There will be a review of capital requirements by the Basel Committee and in the EU, particularly with respect to requirements for the trading book. The broad assumption underlying the Basel Capital Accord – that regulators around the world could rely on firms' own risk models as the basis for capital requirements – has not turned out to be correct, at least for the trading book. Losses in trading books have been several orders of magnitude larger than the capital which the models said had to be held against those risks.

This does not mean, in my view, scrapping Basel 2. The general principle of tailoring capital requirements to risk remains valid. What has, however, become apparent, is that risks are far greater than previously anticipated, and that capital levels will have to reflect the risks that have actually occurred and could occur again. But we will need to change regulation in a manner that avoids unintended consequences and avoids creating new opportunities for regulatory arbitrage.

The net effect will, I suspect, almost certainly be a significant increase in capital requirements. At a minimum, revisions to capital requirements will, in my view, have to take into account the volatility that we have seen over the past year, so that firms would be capable of withstanding extreme events. It would also mean taking into account the possible evaporation of market liquidity. Current proposals for an incremental risk charge, including a charge for event risk, on the trading book point in my view in the right direction.

In contrast, the so-called "skin in the game" amendment to the Capital Requirements Directive may be a step in the wrong direction. This is a requirement that firms keep a certain portion of the asset-backed securities that they underwrite and distribute so as to assure that proper due diligence has been exercised throughout the origination and distribution chain. The requirement will certainly add to costs, but it may not reduce risk. Indeed, the gravest problems in this financial crisis have occurred at banks, such as UBS, which had not just "skin in the game", but "limbs on the line" in the form of tens of billions of dollars of super-senior exposures.

There will also be a hardening in the quality of capital. In the current crisis attention has increasingly focused on capital that is unequivocally and immediately available to bear losses. I would expect this focus to continue, and for requirements to be increasingly framed in terms of Core Tier I capital. Both the Basel Committee and CEBS will be considering these issues.

In particular, I would expect attention to focus on the loss absorbency of capital. Common equity unequivocally provides this. Some forms of hybrid capital do not, in the sense that their terms require the bank to undergo some form of reorganisation or restructuring before losses can be ascribed to the capital instrument in question. What is needed are instruments that supply capital that can absorb losses whilst the bank is a going concern.

Contingent or "top-up" capital may hold significant promise. Such capital could be issued in the form of deeply subordinated debt or preferred stock so that it is junior to deposits, but it would be convertible into common stock in the bank upon the bank breaching some threshold capital requirement. Indeed, encouraging or requiring banks to raise such capital during booms, rather than returning capital to shareholders through share repurchases, may be a suitable form for dynamic provisioning to take. It should certainly be easier and cheaper to raise capital for banks during good times than in the midst of a crisis, when recourse may need to be made to governments as a capital provider of last resort.

Funding liquidity is the next stage in the cycle, and this will certainly receive a great deal of attention. In the UK we are about to reform liquidity regulation and supervision significantly. The FSA will shortly be issuing a consultation paper to introduce a new liquidity regime. This builds on international work undertaken by the Basel Committee and in CEBS. Under this regime each deposit taking institution will be required to undertake an individual assessment of its liquidity risks. These risks include those that could crystallise as a result of a name-specific stress, a market-wide stress and a combination of the two. The regime will also require a bank to manage its liquidity risk – either by managing its assets and liabilities to reduce possible liquidity demands or to hold truly liquid assets to offset possible liquidity demands. The objective is to minimise the possibility that the institution will require emergency liquidity assistance from the central bank, and we anticipate that the new regime, coupled with the possibility for banks to issue longer term liabilities under the government's credit guarantee programme, will lead to a reduction in reliance on overnight funding.

Regulators will also tackle a number of other issues that set the framework in which banks operate. Three are worthy of mention here.

The first is remuneration policies. Firms themselves have admitted that remuneration policies may have been a contributory factor to the financial crisis. Regulators concur. The Financial Stability Forum will conduct a global survey of firms' remuneration policies and develop appropriate recommendations. In the UK, the FSA has written to the CEOs of major firms to assure that firms' remuneration policies are consistent with sound risk management, and we are examining firms' policies to assure that this is the case.

Our concern is not with the level of pay. We have no objection to people earning high compensation, provided they earn it in a manner that is consistent with sound risk management. We do object to remuneration policies that stack the deck in favour of the executive. Such an example might be a bonus system in which the current year bonus is based entirely on revenues, not profit, where the executive in question has a strong influence over determining revenue recognition, where estimates of future profit can be front-loaded into current year revenues, and where the entire bonus is paid to the executive immediately in cash. Such bonus systems can be a one-way ticket to disaster, and firms will need to eliminate such practices.

We have followed up the Dear CEO letter by asking major firms to supply us with information on their remuneration policies, and we will be meeting them individually between now and Christmas to discuss them. In the New Year, we will give feed back to the firms, and hold further discussions where necessary. We will also publish a more general review of remuneration policies in the London market, with a revised statement of what we consider to be good practice. And, we will work closely with other regulators and in the Financial Stability Forum to assure that this problem is tackled on a global basis.

The second framework issue is strengthening the financial infrastructure. This includes continuing to improve the confirmation, clearing and settlement of credit derivatives. Through concerted effort on the part of industry and supervisors, systemic risk in this market has been significantly reduced, first by the elimination of unauthorised assignments, then through the reduction of confirmation backlogs, the establishment of a central data warehouse and the automation of trading. Now regulators and industry are working together to establish a central counterparty for credit default swaps. We expect that at least one CCP will be established in the US and one in the EU around the end of this year. The CCP will be structured so as to withstand the failure of even the largest of its members/counterparties. This will facilitate a significant reduction in risk.

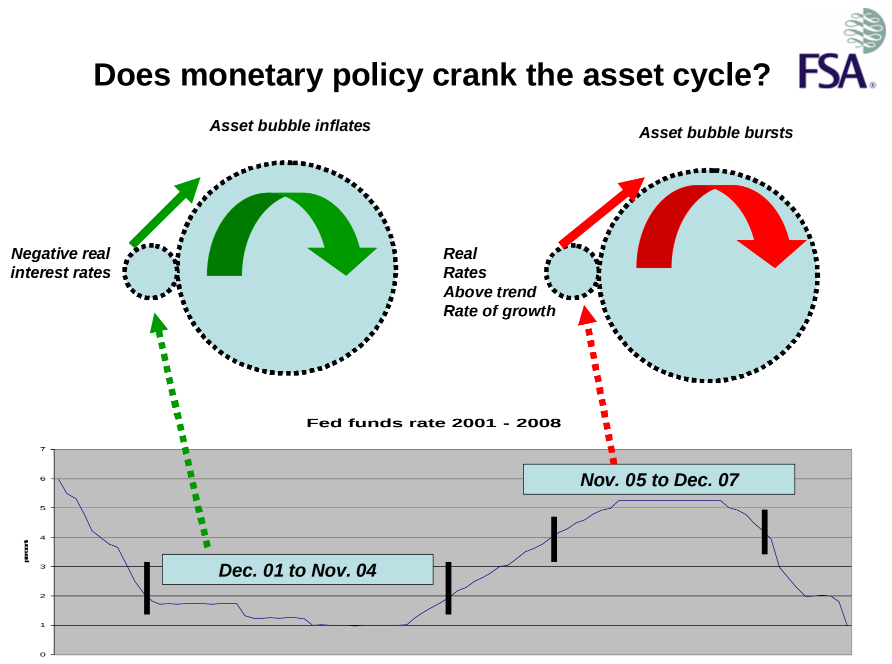
The third framework issue is a method for prompt resolution of failing banks. When things go wrong at a financial institution, it is important to have in place a process that allows the institution in question to be resolved quickly so that consumers are protected, assets are liquidated in an orderly manner that respects the rights of creditors, and shareholders suffer first loss. Until 2008 we did not have such a framework in the UK, and its absence hindered the resolution of Northern Rock. The Banking Special Provisions Act has been an effective stop gap measure that has facilitated the resolution not only of Northern Rock, but also of Bradford and Bingley and the UK subsidiaries of failed Icelandic banks, but this Act will expire in February 2009. To replace it, the Government introduced on 7 October a Banking Bill that will establish a permanent resolution regime for UK banks and building societies and greatly strengthen the UK deposit guarantee scheme. The Banking Reform Bill is very much a product of joint work by the three Tripartite authorities and the FSCS as well as a reflection of the extensive consultation that has been conducted with industry and other stakeholders, including the BBA. The Bill's prompt enactment is essential to preserve financial stability. The EU is now considering measures to facilitate prompt resolution and to strengthen deposit guarantee schemes.

This is a massive regulatory and supervisory agenda, and these reforms will strengthen the resiliency of the banking system. But we should be under no illusion that on its own regulatory and supervisory reform will be enough to prevent future crises. What central banks do with respect to interest rates, reserve requirements and the interest payable on reserves, and liquidity policy (including collateral eligibility, haircuts and rates charged for borrowing) has significant effects on financial stability. Can these classic central bank tools really be used effectively to puncture asset price bubbles before they get out of hand? If so, financial stability will in my view be much enhanced.

But if we are to prevent asset price bubbles from bursting, we must prevent them from forming in the first place. Chairman Greenspan once famously testified that it was not the role of the central bank to puncture asset bubbles, but to clean up after they had burst.

Surely, in light of current events, we must re-examine that stance. Indeed, it is just as important to ask what causes the cycle that we have depicted here from reversing direction from forward (higher asset prices to greater market liquidity, etc) to backward (lower asset prices to lower market liquidity, etc.), as it is to ask how one might dampen the amplitude of the cycle.

The answer, I would suggest, may lie in the realm of monetary policy. Changing the level of interest rates has a powerful, albeit lagged, effect not only on the real economy but also on asset prices. Driving real interest rates below zero is an excellent way to heat up not only the real economy but also asset prices. And that is exactly what the Fed did in 2002 and 2003 following 9/11.



Slamming on the brakes by raising interest rates can have the opposite effect. And that is exactly what the Fed did starting in late 2004. Real interest rates rose dramatically. By the end of 2006 housing prices in the US had stopped rising, and sub-prime borrowers had begun to default on their payments.

A mere coincidence, or cause and effect? If the former, it makes the regulatory and supervisory reforms all the more urgent. If the latter, is this not an argument for better monetary policy as much as for better regulation, and is not better monetary policy as much or more part of the cure for crises as better regulation and supervision?

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