



**DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS
COMMITTEE ON FINANCIAL MARKETS**

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SUMMARY RECORD OF THE OECD FINANCIAL ROUNDTABLE

13 November 2008

This note summarises the discussion of the Roundtable meeting the Committee on Financial Markets (CMF) held with representatives of the financial services industry on the morning of 13 November 2008 on “Lessons from the financial market turmoil: Challenges ahead for the financial industry and policy makers”.

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Lessons from the Financial Market Turmoil: Challenges ahead for the Financial Industry and Policy Makers

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I. Background and summary

Roundtable discussion focuses on lessons from the financial market turmoil and challenges ahead

1. As is customary, the Committee on Financial Markets held its special session with representatives of the financial services sector, the “Financial Roundtable”, prior to its plenary session. The Roundtable is organised in order to provide inputs for the discussion of specific topics of the CMF agenda and to allow for consideration of the private sector’s point of view on certain issues. This Roundtable discussion focussed on the lessons from the financial market turmoil and challenges ahead for the financial industry and policy makers. As specified in the discussion note and the accompanying background paper by the Secretariat,¹ the discussion evolved in three interconnected rounds addressing the following issues:

- Round 1: Assessment by the financial industry of policy actions taken so far;
- Round 2: Evaluation of current proposals by the industry as well as policy makers for financial sector and regulatory reform;
- Round 3: Challenges ahead and elements of a comprehensive regulatory reform.

This time IIF provided major private sector representation...

2. For this particular meeting the private sector participants were mainly invited through the Institute of International Finance (IIF) and represented a range of major financial institutions, including a major monoline insurer, joined by representatives from law firms and consultancies, as specified in the list of participants attached at the end of this document. The co-operation with the IIF for this Roundtable meeting had been proposed because the IIF had released a comprehensive set of proposals as one of the major private sector response to the crisis.² This co-operation also follows up on a previous OECD Financial Roundtable on regulatory issues in which the IIF participated.³

¹ See DAF/CMF(2008)16 and DAF/CMF(2008)16/ADD1, respectively.

² See Institute of International Finance (IIF), *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations*, available at www.iif.com. Copies of the report were also provided at the meeting.

³ See DAF/CMF/M(2006)5, the summary of the Roundtable discussion of 9 November 2006 on issues around the topic “Implementing Basel II in a World of International and Sectoral Convergence”. At that meeting, the

...and lead speakers

2. The discussion in each round was introduced by selected private sector participants acting as lead speakers. The key issues raised and some of the conclusions that emerged from the discussion are recapitulated below.

Selected key issues and conclusions

- Policy actions were greatly welcomed, but they need to be predictable and consistent, and provide a clear exit strategy in cases where government has taken control of banks or issued blanket guarantees.
- Markets need time to adjust before they can resume normal functioning. Further deleveraging will be necessary, albeit costly for the economies.
- A co-operative, global approach is necessary for policy actions as well as supervisory and regulatory reforms; fear was expressed over increasing nationalism ('balkanisation') in these areas. Regulation needs to provide a global level playing field.
- Private sector reform proposals are broadly aligned with official ones, and include global monitoring and co-ordinating supervisory bodies.
- Supervisory rather than regulatory deficiencies caused the crisis, and regulatory capture has been an important issue in this context. Better, not more regulation is needed.
- There was agreement on the need for more scrutiny for credit rating agencies (CRAs), but not on its specification. Investor-based financing of CRAs was seen as a possibility to avoid conflicts of interest, but is also not without problems (*e.g.* free-riders).
- Basel II capital requirements tend to be too low (only 4% equity based, and 4%, in principle, debt based).
- Scepticism was expressed as regards a narrow banking approach, which would be hard to administer and would invite regulatory arbitrage.

II. Assessment by the financial industry of policy actions taken so far

Policy actions were greatly welcome

3. The recent policy actions to address the crisis were greatly welcomed, and many participants expressed confidence they would help markets to return to a more normal functioning. As regards the various types of interventions and the design of rescue plans, all three elements, the provision of liquidity, recapitalisation as well as the purchase of toxic assets were seen as necessary to restore equilibrium. Also, government guarantees

IIF presented a draft of the paper *Proposal for a Strategic Dialogue on Effective Regulation*, finalised and published in December 2006; available at <http://www.iif.com/regulatory/effreg/>.

were seen as helpful. All these policy interventions should, as far as possible, be neutral (if not positive) for the taxpayer. The problem of ‘stigmatisation’ of banks seeking help was not seen as an issue. Regarding the lender-of-last-resort function of central banks, more inter-operability and a wider range of collateral would be welcome.⁴

Markets should be given time to adjust

4. Policy makers seem to be very concerned about the effectiveness of their measures, but cures cannot be expected to work in the short run. Markets should be given time to adjust and absorb the interventions before normal functioning could be achieved. Measures should be applied in a flexible manner, and not all funds that governments pledged for financial sector rescue interventions may need to be used. Interventions should promote confidence building, and try to avoid undermining trust in the system by inconsistent or overly intrusive policies. Policies should be predictable. Going forward, the problem is to deal with the impact of the crisis on the non-financial sector, which has become affected.

Policies need to be predictable, and may need to include an exit strategy

5. Participants also saw a danger that political ambitions were being blended into policy makers’ responses to the crisis, disregarding sound economics. There also needs to be clearer sense and guidance as to which strategies are being followed. In cases where governments have issued extensive guarantees, provided loans or acquired equity participations, it is important to devise a clear, consistent and credible exit strategy. Emergency action should not provide the basis for a permanently larger role for the public sector in the financial system.

Deleveraging is necessary, despite its economic costs

6. Participants agreed that there is too much leverage, if not overcapacity, in the financial system. Deleveraging is highly necessary, even though it will have negative effects also on the real economy. The question of whether there was overcapacity in the system in addition to excess leverage was moot at least as regards the banking sector; it was argued that banks now need to extend their lending capacity in order to support a faltering economy.

7. It was also noted that certain business models that have become increasingly popular with (because profitable for) the non-financial sector, like just-in-time supply chains and relying on outsourcing, had themselves been built on (increasing) leverage and will – painfully – have to adjust.

Insurance companies have fared relatively well during the crisis

8. It was also noted that insurance companies proper (like AIG’s proper insurance businesses) did not have major problems during this crisis. Capital cushions on the asset side related to Solvency II requirements have helped these companies to continue their business almost “as usual”. The drying up of market liquidity was of course an extraordinary, straining situation that also affected insurers’ assets and could have led to a downward spiral. Thus, central banks’ actions to alleviate this problem were very highly welcome.

⁴ In this context, reference was made to the 2007 IIF report on *Principles of Liquidity Risk Management*, available at <http://www.iif.com/press/press+25.php>

A co-operative, global approach is necessary

9. A co-operative approach was seen as necessary for policy interventions and reform plans. Such co-operation should include the private sector (individual affected institutions where necessary), supervisors, regulators and other policy makers. Co-operation also needs to reach across borders, and many participants expressed a fear of nationalistic tendencies ('balkanisation') in governments' and supervisors' actions. Participants expressed only limited understanding for policy makers being concerned only about their own taxpayers and constituencies, arguing that the crisis had global dimensions and needed cross-border solutions.

III. Evaluation of current proposals by the industry as well as policy makers for financial sector and regulatory reform***IIF reform proposals, broadly in line with major official ones...***

10. The IIF in its reform proposals (by the IIF Committee on Market Best Practices) is in broad agreement with official reform proposals such as those issued by the FSF [see the summary boxes in DAF/CMF(2008)16/ADD1]. Proposals have been made with regard to risk management (which also involves a harder to tackle "anthropological" component), including compensation schemes, governance structures, liquidity and counterparty risk, as well as transparency, disclosure, valuation and ratings. Such reforms as proposed should help to restore market confidence.

...need to be implemented

11. In its comprehensive recommendations, the FSF called upon the IIF to follow through with implementation of the IIF proposals. While the Institute saw the need to strengthen its efforts in this respect, its representative argued that a natural first step of further stocktaking and reform gap analysis should take place at the level of the 65 firms and about 170 officers that have been contributing to the IIF reform proposals. Such self assessment, with a view to implementing these reforms, should be encouraged by the IIF and other stakeholders.

Market Monitoring Group to enhance global surveillance

12. It was highlighted that the IIF in its June report also put forward a proposal to establish a Market Monitoring Group (MMG) to enhance and complement official surveillance. The group should help to monitor risks, anticipate shocks to the financial system and thus help to prevent crises. That proposal was explicitly welcomed by a CMF Delegate.

Surveillance needs to be forward-looking

13. In the context of forward-looking surveillance one participant also mentioned that supervisors should focus on scrutinising the businesses where banks made the most money, and not where they lost it, as the former are the most likely areas to create problems down the road.

Capital requirements may be too low, and incoherent across jurisdictions

14. Regarding the question as to whether Basel II had led to regulatory arbitrage by favouring mortgage-backed securitisation and encouraging a steep rise in the issuance of mortgage-backed securities, it was felt that regulatory arbitrage under Basel I, which fostered the growth of off-balance sheet vehicles, was probably stronger. However, the new capital requirements (4/4 split) were seen as a major weakness of Basel II. Only the 4% Tier 1 capital is equity, the additional required 4% Tier 2

capital has a principally debt character. Thus, overall required capital ratios may simply be too low. Moreover, capital definitions differ across jurisdictions and may create competitive distortions. But then again, it was argued that stronger capital cannot be the “solution to everything”, and can only be a complement to sound risk management and other measures that underpin the soundness of financial institutions.

More scrutiny for credit rating agencies

15. There was broad support for more scrutiny imposed on credit rating agencies (CRAs), but many participants favoured an SRO (Self-Regulatory Organisation) approach. Participants also expressed their concern that too much importance is given to CRAs in regulatory requirements, which tends to further increase pro-cyclicality. Ratings should also include a review of the funding framework in order to assess resilience towards liquidity shocks.

Investor-based financing of CRAs as a possibility to avoid conflicts of interest

16. Proposals for more investor-based financing of CRAs were discussed in order to alleviate conflicts of interest that rating agencies tend to have in rating their clients. While this would tend to improve the accuracy of ratings, such financing is not without problems. As there is no natural market for ratings (they have a public good aspect), ratings create free-rider problems. A solution could then be to oblige stakeholders (issuers and/or investors) to pool their contributions in order to finance ratings.

Standardisation of structured products could help to enhance transparency

17. It was noted that the excesses of the originate-to-distribute (OTD) model had led to a massive shortage of high-quality securities, and favoured the issuance of ever more complex structured products. Due diligence was lacking at all stages of the process, from mortgage brokers to the final investors in mortgage-backed securities. More standardisation regarding structured products’ documentation would enable credit rating agencies and investors to better assess these securities and thereby help to enhance transparency and restore confidence. At the same time, the importance of the OTD model may decline and securitisation structures may again become much simpler, which would render the arguments for increased standardisation and disclosure academic..

Procyclicality of valuations

18. Valuation bears the danger of procyclicality, but fair value standards should be respected. This is, however, a very general term, and valuation principles (especially regarding model-based valuations which can differ widely from one company to another) should try to avoid distortions and maintain a level playing field.

Monolithic risk-management approach should be avoided

19. As to risk management, it was suggested that a monolithic approach should be avoided, as it turned out that companies that used such an approach were the ones that had the most problems. Thus, some recent reform proposals embracing such an approach are probably promoting the wrong response which, if implemented, could form the basis for the next crisis.

IV. Challenges ahead and elements of a comprehensive regulatory reform

- Supervisory rather than regulatory deficiencies caused the crisis*** 20. With regard to regulatory reforms, participants felt that speaking out against overregulation may not seem appropriate under the current circumstances. However, it was pointed out that the crisis was caused by supervisory deficiencies rather than regulatory ones. Thus, what is needed is not more but better regulation. The level of regulation in general is sufficient, but specific improvements (e.g. regarding capital requirements or rating agencies, as mentioned) are needed and welcome. In this context it was mentioned during the discussion that the IIF Committee on Effective Regulation⁵ is planning to resume its work and may be able to provide further support in identifying areas where regulatory reform is necessary.
- Sound management as prerequisite for regulatory compliance*** 21. Sound management, including IT systems, was underscored as a prerequisite for compliance with supervisory and regulatory requirements. Minimum standards should be fulfilled in this respect. This also includes sound internal financial and risk controls, which should be reviewed continuously to ensure their robustness and highlight weaknesses.
- Supervisors need competence*** 22. On the side of the supervisors, strong skills should be requested, perhaps implying higher, industry-compatible salaries. This should foster strong, competent supervision.
- Supervisors need to stay independent and avoid regulatory capture*** 23. It was also stressed that supervisors need to stay independent. ‘Regulatory capture’ could be a problem in particular in supervising large, systemically important institutions, when certain outcomes to which resources are devoted by the ‘capturing’ institution meet with (political) interests of the regulators or supervisor. Also, under favourable economic conditions more leniency tends to come from regulators with respect to scrutinising financial innovations that themselves help to boost growth.
24. But then again, one participant noted that ‘good’ regulation should try to align official and industry interests to the benefit of all.
- Complexity should be reduced, but not at the expense of innovation*** 25. Regulators should try to cut back on complexity, as complex structures are hard to implement and supervise. But then again, in cutting back on complexity, regulators should be careful in seeking to prohibit outright certain types of businesses, as this may stifle innovation and growth.
- Scepticism as regards Glass-Steagall type regulation*** 26. In this context, some scepticism was expressed with regard to a new Glass-Steagall type of regulation, which may be hard to administer and would invite arbitrage. A narrow banking approach would invite banks to do other business in unregulated entities, which, as was noted, would go against EU regulators’ ambitions that “there should be no place to hide” from regulation. Separation of business in separate legal entities (like in Germany and Italy, for example) or separate silos (with separate accounting units) would be ways to go.

⁵ The name in full is IIF Special Committee on Effective Regulation; see <http://www.iif.com/regulatory/effreg/> and the report *Proposal for a Strategic Dialogue on Effective Regulation* issued by that Committee in December 2006, also referenced in Footnote 3.

Firm structures should facilitate proper pricing of risk

27. As was highlighted during the discussion, the most important issue is that any structure should facilitate, and perhaps enforce, proper pricing of risk, including liquidity risk, be it within the firm or via external affiliates. Company structures should then also allow sound risk management and controls for the firm, and enable insight into such procedures by supervisors.

Scope of regulation is moot

28. Views were less clear cut regarding the scope of regulation; however, participants did not argue against a more comprehensive approach. In this context, it was pointed out that the largely unregulated hedge funds had not been a trigger to this crisis, and many of them have gone under without having caused collateral damage.⁶

International co-operation of supervisors and regulators is essential

29. International co-operation of supervisors and regulators was seen as essential and in need of reinforcement. In its recent letter to the G20 (available at www.iiif.com), the IIF proposed a Global Financial Regulatory Co-ordinating Council which should facilitate cross-border regulation in an increasingly global financial system. Such a Council should comprise the Basel Committee, IOSCO, IAIS, and leading central banks from G20 countries, with the FSF as an umbrella. It would enable co-ordinated oversight of individual systemically important firms more efficiently and could help facilitate a cross-border macro-prudential approach to regulation, in order to minimise systemic vulnerability and risk.

Global approach against fear of nationalistic tendencies

30. The issue of international co-operation and co-ordination inherent in these proposals was also supported by other participants, and the potential of such initiatives to better prevent future crises was underlined. As earlier, the fear of nationalistic tendencies was stressed. The supervisory college approach was welcome, but should be developed further through enhanced international supervisory co-operation. This is especially relevant for large, systemically important internationally active financial institutions.

31. The promotion of a global implementation of Basel II as well as international accounting standards (IFSR) was seen as useful in this context, as they should help to create an international level playing field for the global financial sector.

⁶ N.B.: It is noteworthy that it were collapsing hedge funds that caused the problems of Bear Stearns, one of the early victims of the subprime crisis (June 2007), but these funds were Bear Stearns' affiliates and probably (internally) funded and geared up at too favourable conditions, not taking proper account of risks.

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13 November 2008

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