EU Financial Services Law and the Challenge of the Global Financial Crisis: Is the Existing Regulatory Framework Adequate?

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What is the Global financial crisis?

- Banks do not lend to each other so inter-bank lending is cut-off
- When banks do lend funds to each other it is at a very high interest rate, e.g. on October 2 Fed's base rate stood at 2%, but Libor stood at 5.35% (cost of lending in USD 3.35%)
- Investors do not buy bank debt (bonds) or bonds of securitized loans so no other source of wholesale funding is available
- Investors sell bank shares because they lack confidence in their financial health diminishing their market capitalization
- Banks **DO NOT LEND money to CONSUMERS, SMALL BUSINESSES, LARGE CORPORATIONS**
- When they do lend the interest charged is much higher than in previous periods and thus onerous

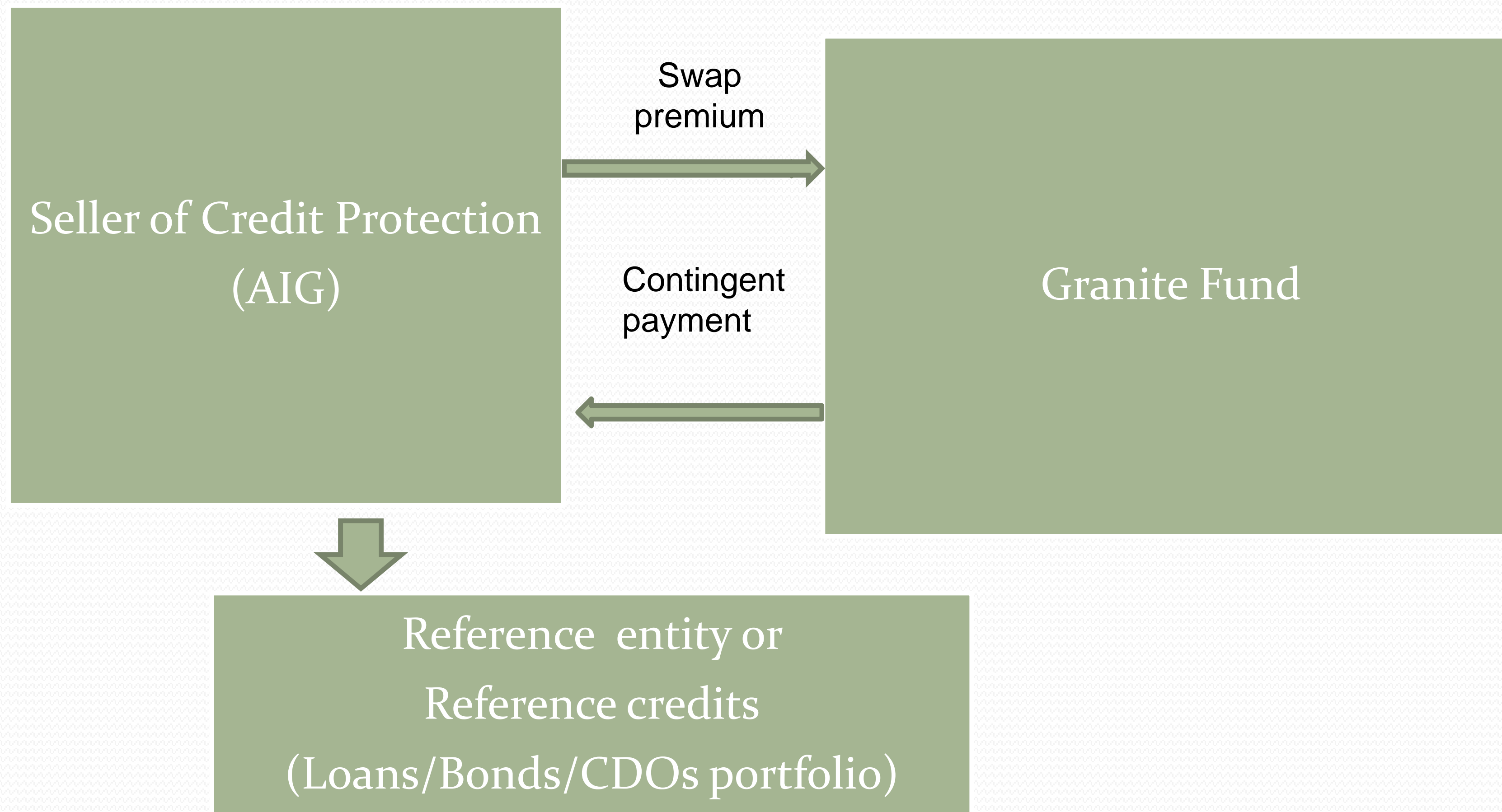
What caused the crisis

- **Gigantic credit expansion due to unusually low interest rates and benign macro-economic conditions which led to:**
- Very high leverage ratios
- Asset inflation caused by credit expansion
- **Lax credit controls:**
- due to excessive availability of credit
- loss of the lender/borrower relationship due to securitisations which relaxed due diligence
- **The *originate to distribute* model was based on commission generation not credit controls**

What caused the Global Financial crisis?

- Complexity of financial instruments which made them impossible to value
- Collateralized Debt obligations (CDOs) and Credit Default Swaps (CDSs) just relocated and spread instead of eliminating credit risk, **BUT**
- they piled up systemic risk
- Credit risk accumulated hidden from the market and regulators in SIVs and insurers so nobody could calculate
- Credit Rating Agencies failure to properly calculate risk because of conflict of interests and flawed methodologies
- serious governance and risk management weaknesses within large financial institutions
- Lax supervision/inadequate regulation (e..g Basle II)

Typical Credit Default Swap (CDS)



Why the Credit Rating Agencies Were so Important?

- *It is very* hard for investors in a CDO and other structured credit securities to understand all risks involved. The banks needed the packages to be rated by an independent and reputable third party - the credit rating agencies.
- The ratings first homogenized structured credit securities and made them easily tradable facilitating transactions
- Second the higher ratings, e.g., AAA, gave investors comfort that the purchased securities, which did not really understand in its mechanics, had some sort of intrinsic value reflected in the rating

What was wrong with Credit Ratings?

- The creation of the packages and their rating were not independent rather they were influenced by **conflicts of interest** both indirectly and directly since:
- Credit rating agencies being paid by the issuers of the structured debt securities gave banks software that enabled them to input a package of debt instruments and see what rating that package would acquire –
- As a result packages were "built to rating"
- The methodologies used were inadequately stress-tested and probably flawed
- SOLUTION: **An independent EU or global regulator that will stress-test methodologies and will monitor code of conduct**

What triggered the Global Financial crisis

- **The Housing bubble in the US bursts**
- **Why?**
- The big number of mortgages of 100-120% of house value were a pyramid:
- not only they assumed perennial increases in house prices but also buyers willing to keep buying them at ever increasing multiples of their income (i.e., they assumed that a fool is born every minute)
- in fact, average US incomes were going down year after year
- **The first to be hit was the US sub-prime mortgage market**

Why did the US Sub-prime crisis become a global crisis

- Due to the use of securitisations and the purchase of CDOs and CDS a large number of hedge funds, investment funds, and big US and EU based banks had bought those instruments and were now burning their own capital
- The market lost all confidence in the value of credit ratings
- As a result, the secondary market in CDOs dried up and no value could be placed on bank and fund holdings of CDOs

Weaknesses of Cross-border Banking Supervision in the EU

- Lack of a Pan-European systemic stability regulator: a serious weakness that makes the task of banking market integration impossible in the modern market environment where risk transmit rapidly across borders in a highly contagious climate
- The principle of home country control has proved inadequate:
- Supervision of cross-border banking is fragmented,
- Room for co-ordinated action in times of crisis limited
- Too much emphasis on the Basle Framework

Specific Weaknesses Highlighted by the Crisis

- Any distinction between crisis prevention (prudential supervision) and crisis management is meaningless
- liquidity provision must be through a Lender of Last Resort (LoLR) but the decision is taken by the supervisor and the ultimate guarantor of the LoLR funding (the state(s))
- The existence and administration of a special bankruptcy regime is of crucial importance to the response of the system to the crisis
- The ESBC/ECB structure is flawed since there is no link between the LoLR function and bank supervision

Proposals

- Single Regulator
- A Pan-European **cross-border** Bank/Securities markets Regulator
- The same body also decides to use liquidity lines open to it by the ECB and the Member States
- A harmonized special bankruptcy regime
- A Pan-European FDIC administering deposit guarantees and the op
- Complications
- Political issues:
- Member state mistrust
- Power struggles: who runs what?
- Conflict with domestic bankruptcy laws

The Trouble with Basle

- Capital Requirements Directive (CRD) for credit institutions and investment firms incorporates the rules and standards on capital measurements and risk-based supervision contained in the Basel II.
- **Basel II did not regulate liquidity**; as a result, liquidity controls became a rather neglected supervisory tool with no harmonized set of rules/guidelines with which banks had to comply with
- Low levels of liquidity in otherwise well regulated banks proved the **Achilles heel** of the system in the early stages of the global crisis exacerbating the downward spiral of asset prices in a falling market, as banks had to sell massively securities in order to generate liquidity
- As a result of Basel II and lax supervision **EU banks proved to be under-capitalized** thus a liquidity crisis soon turn into a **solvency crisis**

The Trouble with Basle

- It's pro-cyclical: it forces banks to lend more in good times rather than in bad ones when the economy needs credit most
- The model is a flawed regulatory tool:
- while it attempts to approximate a bank's regulatory capital to its economic capital it makes no provision for the externality of systemic risk –
- it fails to protect society from the social cost of excessive bank risk-taking and opportunistic bank behaviour, whereby the bank boosts its balance sheet and thus its profit-making opportunities, without being forced to take regard of the systemic risk that is piling up in the normally under-capitalized banking system.

Securities regulation

- **Disclosure under the Market Abuse rules**
- Secret bank rescues were impeded by current rules
- Colossal disclosure omissions by banks under the current climate
- **Inconsistent implementation:**
- e.g., the treatment of short-sales
- Legal until September/illegal afterwards
- Why the change of position?
- **Inconsistent Enforcement**
- There shall never be a truly integrated market if enforcement practices remain disparate
- CESR must harmonize regulatory rulings and the Directive must be amended to provide they bind national regulators