CRIS Public Hearing "The Financial Crisis: Causes, Consequences and Challenges" Tuesday 10 November 2009

Speech by Verena Ross

Thank you Mr Chairman. I am very honoured to be able to speak here today about the causes of the financial crisis. It is very valuable and timely that the European Parliament has decided to dedicate this special committee's time at this hearing to review the extent of the crisis and consider what steps need to be taken to reduce both the probability and severity of future crises. The UK's Financial Services Authority is keen to participate in this analysis and search for solutions. Indeed, we have been very open and transparent about both the wider causes and possible solutions as well as the problems the FSA faced specifically in its supervisory task and how to address those lessons learned. I am planning to spend about half of the time kindly allotted to me to talk about the origins of the crisis and the other half about the lessons to be learned, with a particular focus on the EU agenda.

The financial crisis which began in the summer of 2007 and intensified dramatically in September last year, was certainly the worst crisis since the 1920/30s. Economic catastrophe was only prevented by extreme and unprecedented government policy responses. The world has faced huge economic costs as a result of the crisis, in terms of lost output and wealth as well as unemployment. Therefore, fully understanding the causes of the crisis is extremely important to ensure that the right policy response is chosen going forward. I am glad that we will spend some time this afternoon discussing these issues.

I believe there is now considerable consensus on many of the origins of the crisis. We have outlined our view very publicly in the Turner Review that was published in March this year. Let me briefly run through and remind ourselves of the key features of what went wrong. I have a few slides that I will use to visualise some of the points I am making.

1) First, there is the broad macro-economic context, with very large current account imbalances [Slide 1] which, combined with fixed exchange rate policies, drove huge accumulation of official holdings of low risk government securities, driving real risk free interest rates down to historically low levels. [Slide 2]

2) Second, these low real and also nominal interest rates, in turn drove a frantic search for yield among investors seeking low risk - or at least apparently low risk - returns. A demand which was met by financial innovation - the explosion of securitised credit, structured credits and credit derivatives, the alphabet soup of CDS and CDO and CDO squared. These instruments were predicated on the assumption that by securitising, structuring, hedging and distributing, investors would receive combinations of liquidity, risk and return more favourable than some of the underlying pools of assets.

3) Third, financial innovation combined with low interest rates, helped drive rapid credit growth in several countries. Due to easily available money, credit standards were lowered in many markets - particularly in residential and commercial real estate. With this easy money, household debt increased significantly. [Slide]

4) Fourth, there was a significant increase in leverage across the system, both at the level of institutions - banks and investment banks - and embedded within products. This leverage in turn further fuelled credit growth. [Slide 3]

5) Fifth, there were profound changes in the scale and nature of maturity transformation in the system - with increasing reliance on the assumption that

contractually long dated assets could be considered liquid because they were saleable in liquid markets; increasing reliance of many banks on potentially volatile whole sale funding markets; and the growth of maturity transformation arising not on the balance sheets of banks but in off-balance sheet vehicles, on investment bank balance sheets and in mutual funds.

These five underlying features created a system of greatly increased systemic risk and fragility: a system highly susceptible to a surge of irrational exuberance and highly vulnerable when that exuberance turned into doubt and despair. They also created a system in which the financial sector had grown significantly within the overall economy, with activities internal to the banking system growing far more rapidly than end services to the real economy. This becomes clear when you look at the following slide that shows debt as a percentage of GDP by different borrower types. [Slide 4] I am afraid I only have this slide for the UK (rather than for the EU), but we have certainly seen similar growth of the financial sector in the US. This growth of the relative size of the financial sector increased the potential impact of the financial system instability on the real economy.

It is essential that we learn - the often painful - lessons from this crisis. Many have already contributed to explaining the key lessons we need to learn from the events that took place, among them Jacques De Larosiere in his De Larosiere Report to the European Commission. Radical changes to our regulatory approach and regime have been proposed and challenging timetables set. The main features of these responses are:

- Capital and liquidity regulation reforms to make the banking system a shock absorber rather than a shock amplifier in the economy. We need more capital (especially in the trading book), better quality capital, more liquidity and a counter-cyclical element to the capital regime.

- Reforms that deal with large systemically important, and potentially too-big-to fail institutions, with possible capital surcharges and/or resolution procedures which would enable a controlled wind-down (allowing some parts of the business to 'fail' while ensuring the ability to 'continue service' of other aspects of the business).
- Action to reduce the inter-connectedness in some of the markets, for example by migrating many of the derivatives markets contracts from OTC into centralised clearing.

In any response we need to remember the international nature of the financial system. The challenge is that we have a global financial system with global banks and investment banks, global capital flows and global capital markets, which move together and can not be separated. Legislation, regulation and government support however is national - this dichotomy has been well described by Bank of England Governor Mervyn King when he said 'global banks are global in life but national in death'. We are therefore required to think not only nationally and regionally about possible solution, but need to do so at a global level. This morning I gave evidence at the ECON committee looking at the Alternative Investment Funds Management Directive, doing so from the global IOSCO (securities regulatory) perspective - as I co-chair the IOSCO Task Force on Hedge Funds.

We do need to agree common rules at the global level, whether that is in relation to capital and liquidity or whether that is vis-à-vis hedge funds and OTC markets. We also need to intensify global regulatory cooperation, through day-to-day supervisory colleges and cross-border crisis management groups. This does not mean that there is not a valid and important role for regional and/or national regulatory responses that address the particular issues and concerns in those markets and financial systems. We should aim however to find solutions which are at least compatible with the global regulatory approach rather than work against it. The European Union needs to do its bit therefore to speedily work with other regions and national and global authorities and decision makers to implement the necessary key reforms I have spoken about above. This means for example helping to translate new capital and liquidity requirements into law, as the revisions of the CRD are aiming to do. However it also means providing the lead and setting the tone in areas where global consensus might not be easily achieved. It is not necessarily about being the first to push legislation through but about making sure that decision makers across the world understand the issues and learn the necessary lessons. Often that requires careful analysis and a good understanding of how financial markets operate and how they interact.

The EU has a big advantage over the rest of the world. It has a much more integrated and advanced single market with free movement of goods and services, based on a Treaty and strong governance institutions as well as a high degree of commonality when it comes to legislation and rules that govern these markets. However the EU structure and framework has also presented particular challenges in the crisis. With the right to operate as branches based largely on home country supervision, many banks and other financial institutions have expanded rapidly across the Union and often 'outgrown' their home country. This has led to problems when it came down to having adequate funds in the relevant home country financial compensation schemes and, indeed, in the ability of the respective governments to rescue these significant institutions.

We believe that the broad aims of the De Larosiere Group, outlined in their report February 2009, are very helpful to take the EU forward - being able to learn from the issues that have arisen in the current crisis. We support a greater common approach to rule making and ensuring that those rules are properly and consistently implemented across the various Member States. These rules need to be made in a transparent way that takes into account their impact on competition within the single market and that the EU is competitive globally. This will require greater cooperation, effective peer review and strong day-to-day communication through supervisory colleges. The new European Supervisory Authorities will play an important and welcome role here. What it does not mean however is that you can diverge day-to-day supervisory responsibility from the ultimate responsibility of Member States to fulfil their home state obligations - including, where necessary fiscal support when an institution gets into trouble. We also support the establishment of the European Systemic Risk Board. Having a greater ability to analyse and identify risks arising from the interconnections between macro-economic and micro-economic environments is another key learning point from the financial crisis. This type of analysis and debate, bringing together central banks and supervisors, is important at national, EU and global level.