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Rebuilding Confidence in the International Financial Markets

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I am indeed delighted to be here this evening, and would like to thank the organisers for inviting me and giving me a free hand on the topic. But I am sure it is no surprise that I have chosen to speak on "Rebuilding Confidence in the International Financial Markets". This is, after all, the priority of governments, regulators and market participants.

My remarks this evening will consider four questions:

- First, what went wrong that needs fixing?
- Second, has the financial sector strayed too far from its fundamental purpose?
- Third, what are the international initiatives to rebuild confidence?
- Finally, how can market participants help to rebuild confidence?

What went wrong that needs fixing?

The origins of the financial crisis bring to my mind an ill-fitting COLLAR that causes such discomfort and distress that it might even choke the person! Each letter in the word "COLLAR" reminds me of the factors that contributed to the financial crisis:

- **Complex** financial innovations that have created underappreciated risks and global interconnections that transmit and amplify shocks;
- **Opaque** markets in financial instruments and shadow banks that no one knows exactly what and how large the risks are and who held them;
- **Liquidity** that lowered yields and risk premiums, encouraging financial innovations which changed the business models and financial landscape;
- **Leverage** that accelerated and supported huge positions in complex financial instruments, as complacency over risk led to lax lending;
- **Accountability** that was eroded by inappropriate incentive structures and poor governance which encouraged excessive risk taking; and
- **Risk Management** that broke down due to over-reliance on risk models built on historical assumptions of unusually low interest rates, thriving financial markets and steady economic growth.

Has the financial sector strayed too far from its fundamental purpose?

15 September 2008 will be remembered as the day that Lehman Brothers failed and triggered a crisis of confidence that caused the interbank and wholesale credit markets to freeze up. The impact was a financial meltdown, and as credit, which is the lifeblood of the economy, dried up the world plunged into the first globally synchronised economic downturn.

Lehman has clearly demonstrated how widespread the knock-on effects of a credit event could be on the entire financial system. Imagine the situation if AIG, a major issuer of CDS, was not given a lifeline.

Recent financial innovations have increased the inter-connections in a non-transparent manner so that there are no adequate circuit breakers. The result is a financial network that was gridlocked when a fuse blew up in the subprime market and spread across to other markets.

According to the BIS, CDS surged more than five times the outstanding principal of global corporate bonds by the end of 2007. Three years earlier, in 2004, the corresponding number was only 85%[1]. Today notional CDS is estimated at $62 trillion.

These numbers are staggering and provide some idea of the huge appetite for risk and the growing importance of these derivatives as new asset classes for all types of investors.

One takeaway from the crisis is the need to bear in mind that finance is a means to an end, and not an end in itself. The role of a financial system is first and foremost to serve the needs of the real economy.

If financial transactions grow out of proportion to the needs of the economy, it would create excessive risk that could pose a serious threat to the real economy. In short, there needs to be balance.

Financial innovation is important but it is not everything. Financial stability is equally important for sustained economic growth and prosperity.

What are the international initiatives to rebuild confidence?

As in any post-crisis situation, there is always a demand for more regulation to plug the loopholes. At the same time, there is recognition that over-reaction in tightening regulation could kill the market. Getting the right balance between regulation, incentive structures and market discipline is not easy.

The first priority of national authorities in the major markets in managing the crisis was to ensure the continued functioning of financial markets. They responded on three fronts to restore confidence and stabilise the financial system:

- Guarantee of bank deposits and bank debt;
- Provision of liquidity to banks; and
- Recapitalisation of financial institutions.

Stimulating the economy to counter the recession was the next battlefront. Governments around the world took action to introduce fiscal stimulus packages.

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[1] CDS allows a bond holder to seek protection against a credit event (e.g. bankruptcy), or to obtain credit exposure to the reference entity without actually holding a bond (i.e. taking a bet on the likelihood of a credit event).

Given the global nature of the current crisis, national authorities acting alone are not sufficient. Global solutions are called for. The international community, such as the FSF, BIS, IOSCO, IMF and World Bank, have been engaged in efforts to:

- Identify the weaknesses and gaps in regulation that have increased the vulnerability of the global financial system
- Recommend measures to strengthen the regulatory framework and global financial system
- Strengthen international cooperation among financial regulators and authorities

IOSCO amended the Code of Conduct for Credit Rating Agencies (CRAs) to address issues which have arisen during the turmoil in relation to the activities of CRAs in the market for structured finance products. It also set up three Task Forces to consider the following issues: short selling; unregulated financial markets and products; and unregulated financial entities.

The G-20 Summit in Washington last November agreed on five principles to guide financial market reform and established four Working Groups to implement these principles:

- Strengthening transparency and accountability
- Enhancing sound regulation
- Promoting integrity in financial markets
- Reinforcing international cooperation
- Reforming international financial institutions (IMF, World Bank, FSF)

The finance ministers and central bank governors met last weekend in preparation for the G20 Leaders Meeting on 2 April. Some of the recommendations that emerged are:

- Ensure all systemically important financial institutions, markets and instruments are subject to appropriate degree of regulation and oversight, and hedge funds or their managers are registered and disclose appropriate information to assess the risks they pose.
- Have regulatory oversight, including registration of all Credit Rating Agencies whose ratings are used for regulatory purposes, and compliance with the IOSCO code.
- Financial institutions should continue to work to strengthen the infrastructure supporting OTC derivatives markets. For credit derivatives, this should include standardizing contracts to facilitate central counterparty clearing for eligible contracts. In addition, central counterparties should be subject to transparent and effective oversight

How can market participants help to rebuild confidence?

The conduct of finance is based on trust and confidence. National authorities and regulators have taken steps and are continuing with efforts to return the financial system to normal market functioning.

Markets have to regain the trust and confidence of investors. It is in their own self-interest to tighten up their own discipline through strengthened risk management, incentive structures, governance, ethics and conduct.

Regulation cannot guarantee against zero failures or against crises happening. The financial system is only as strong as the weakest link in the system. For financial markets to remain robust and well-functioning, it calls for the exercise of self-discipline, market discipline and regulatory discipline by the different stakeholders in the marketplace.

The three disciplines work like a three-legged stool. The stool cannot stand if one leg is missing. The exercise of each discipline reinforces one another in a virtuous circle:

- The exercise of self-discipline by corporations and market intermediaries means having in place robust risk management and internal control systems which provides the necessary checks and balances to guard against excessive risk-taking.
- Regulatory discipline helps to reinforce self-discipline through regulatory requirements and guidelines, as well as compliance checks and enforcement action to deter market abuse.
- Market discipline is equally important, as investors and counterparties in financial markets exercise due diligence and vote with their funds allocation, thus providing the necessary pressure and incentives for fund raisers and financial intermediaries to have sound risk management and internal control practices (i.e. self-discipline).

Concluding remarks

In concluding, I would like to make a few observations. First, the cloak of the present crisis may look different – subprime loans, CDOs and the originate-and-distribute business model. But the underlying problem is the same – availability of cheap and easy credit, lax lending standards, weak risk management culture and inappropriate incentive structures.

Second, the stability of markets is dependent on the different stakeholders acting in a responsible manner. The market is only as strong as the weakest link in the system. This calls for the collective exercise of self-discipline, market discipline and regulatory discipline by the respective stakeholders. The discipline works like a three-legged stool; it would not stand if one leg is absent.

Third, the financial crisis has clearly demonstrated the forces of globalisation and its impact. Regulation and policies are national in scope and reach, but the problems in global financial markets demand a global solution.

Finally, if one looks for the silver lining of this crisis, it is that it has brought together concerted efforts at the national and international levels to take the necessary measures that would restore market confidence, and to strengthen regulation and the international financial architecture.

Thank you and have a pleasant evening.