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Making finance serve society

"HAVE THE LESSONS FROM THE FINANCIAL CRISIS BEEN LEARNED?"

Introduction and mission of FW

- It is my pleasure to be here and speak to you during this timely hearing. I'm especially happy to speak during this panel, since Finance Watch's experience and analysis certainly could help to answer that question.

- The purpose of establishing Finance Watch was **to create an independent, public interest voice to counterbalance the private interest view of the financial industry on what types of reform and financial system are needed.** With the resources we have, we have tried to stir the debate to better reflect the interests of society at large. The need for an alternative, independent voice in the debate was the clear purpose of the creation of Finance Watch.

REFORMS

- Up to this point a lot has been said about the roots and consequences of the crisis. As a consequence there was an **international commitment at G20 level to financial reform** to ensure that we learned the lessons.
- The Commission and the Parliament should be applauded that they managed to put in place so many reforms stabilizing the sector.
- What is, however, important to realize is that most of the reforms **are micro-prudential,** meaning they are aimed at making individual financial institutions safer, **but almost none are macro-prudential**, aimed at making the financial system as a whole safer.
- BSR failed to materialize, shadow banking reforms replaced by the promotion of shadow banking,
- The overwhelming objective of **financial sector regulation is stability**, so that both growth and job objectives are met in a sustainable manner.
- The reforms put in place have **failed to address the excessive complexity** of the financial system and of financial regulation, leaving **plenty of opportunities for financial institutions to avoid regulation**.
- **CRD4 is a very good example** of that: we failed to **remove the use of excessively complex internal models** and the opportunities for regulatory arbitrage that go with them. We also have yet to give a **more prominent role to simpler and more robust metrics**. We failed to impose high enough capital requirements and we are now arguably compensating by creating another layer of complexity through bail-in.

This brings me to the subject of today's hearing: securitization.

Securitization and crisis used to be seen as cause and consequence of the crisis. Now securitization lies at the heart of the newly launched agenda for jobs and growth in Europe.

As more will be debated on securitization itself during the second panel I will try to focus on the question for this panel "have the lessons from the crisis been learned?"

The simple answer is NO.

Focussing on securitization, I will try to explain what happened before the crisis and what we are doing now:

1. First**, before the crisis a misalignment of interests between originators and investors resulted in very loose underwriting criteria for the underlying loans in securitizations.** Risk retention at 5% does not address such misalignment of interests. It should be raised to 20% or more and only achieved through a vertical slice of all tranches.
2. The second issue was the **complexity of transactions, in particular tranching** creates excessive complexity and conflicts of interests between holders of different tranches.
3. The third issue was an **excessive reliance on ratings agencies and conflicts of interests between rating agencies and investors**. The lesson here is twofold: first investors should be encouraged to perform their due diligence instead of relying on external assessments. Secondly, there should nevertheless be an entity in charge of assessing compliance with STS criteria. This entity should arguably be a public agency, given the responsibility it will have towards investors.

4. Finally, the issue of **synthetic securitization.** There is ongoing discussion to allow it inside the STS framework. Let me take a minute to elaborate on that.

   Multiple academic work:

- Franke and Krahnen (2007), Allen and Galle (2006) and Uhde and Michalak (2010) show empirical evidence that **synthetic securitization increases the European's bank systemic risk.**
- Also as advised by the **BCBS-IOSCO work streams, only true-sale or cash securitizations should be eligible for the STS label**, thereby keeping synthetic securitization out of the scope. This is also consistent with the ECB framework for refinancing operations, where synthetics are not accepted as collateral by the central bank.

  Even the Commission in its Impact Assessment clearly stated that synthetic securitization is excluded from the framework because the additional complexity of such products (regardless of whether they are undertaken for arbitrage or risk mitigation reasons) requires further work in setting up these criteria.

  Therefore we believe that the discussion about the inclusion of synthetic securitization in the STS framework should be stopped and we expect the Commission to follow the Better

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Regulation principles in providing an appropriate impact assessment to explore further the need, if any, for such securitization to enjoy different treatment.

CONCLUSIONS

- We know what the lessons are but we have a short memory.
- It is essential to realise and **acknowledge that the mission is not accomplished**, that much remains to be done and we should **resist the temptation to have a short-sighted focus** on near-term GDP growth at the cost of future instability at a time where we haven't finished paying for the last crisis.
- We should refrain from dismissing strong academic arguments as irrelevant, and ignore the arguments of sophisticated players who stand to benefit from STS and who argue that "this time is different".
- Therefore we should always bear in mind that good regulation is essential to the fairness, efficiency, and effectiveness of economies, and making it work well is a never-ending mission.