Australian Business Economists

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Unwinding extraordinary policy measures:
what does it mean for economies and investors?

Friday 07 August 2009, Sydney

OECD ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

The Financial Crisis: Is It Safe?

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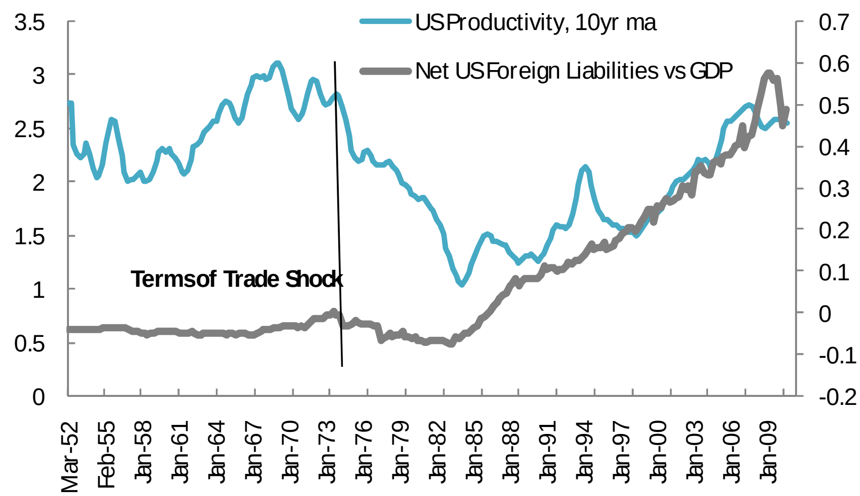
Aug-2009

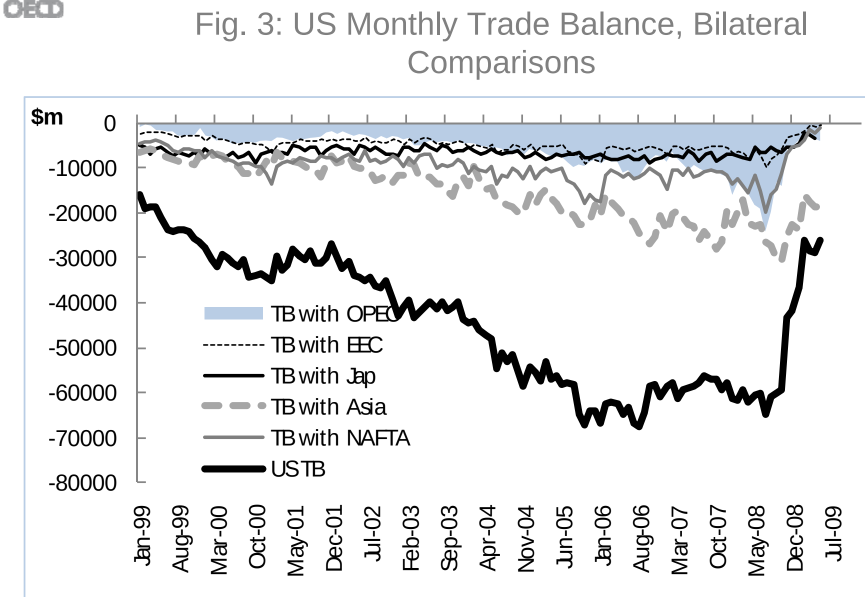
Fig 1: The Crisis Causes/Symptoms

- Macro liquidity excess—the overfilling dam.
- Basel system and capital arbitrage—(cracks in the wall).
- Tax arbitrage & CDS—(cracks in the wall).
- Leverage rule changes for US investment banks: consolidated SEC supervision to lax European standards.
- Too big to fail (systemic size).
- Overlapping and captured regulators. (OTS for AIG!!!).
- Poor corporate governance/risk control.
- Not enough capital/losses/deleveraging & raising capital starts = recession.
- Massive support packages: liquidity, fiscal, loans, guarantees, bad banks—you name it they did it.

Fig. 2: US Productivity



Source: Datastream, OECD



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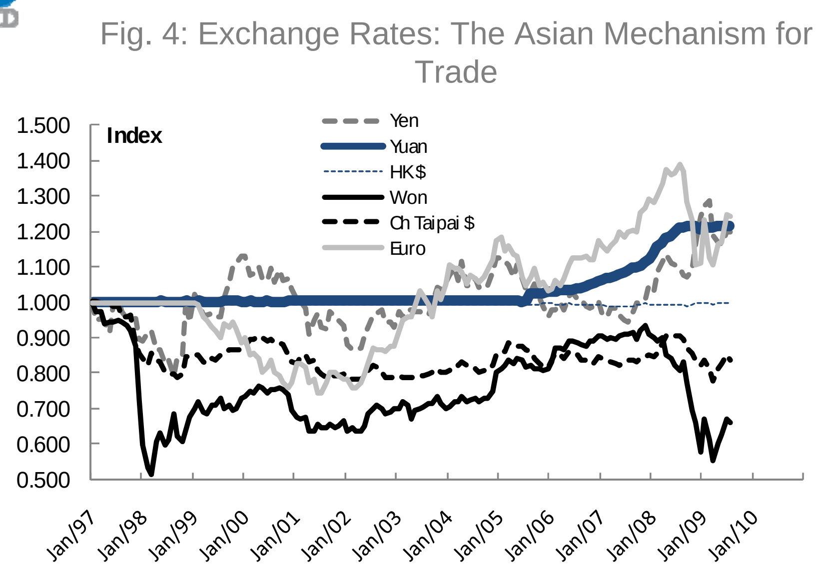
Source: Datastream, OECD



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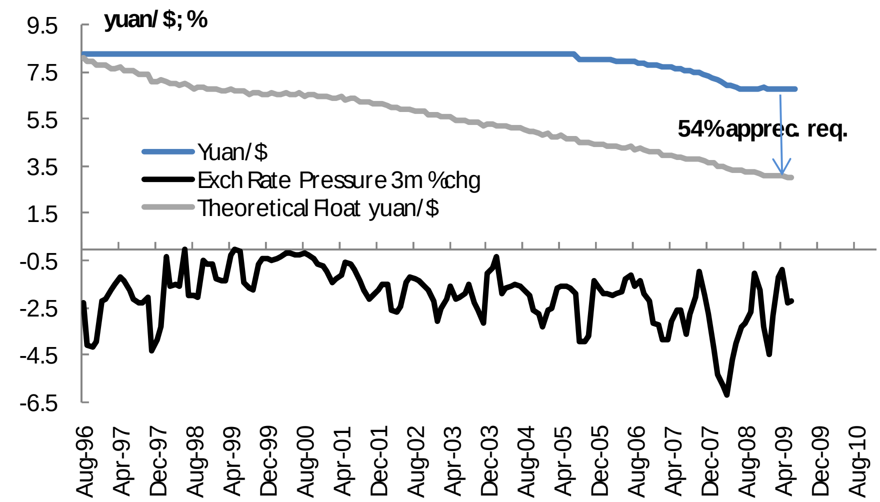
Source: Datastrean, OECD

Fig. 5: Chinese Exchange Rate Pressure



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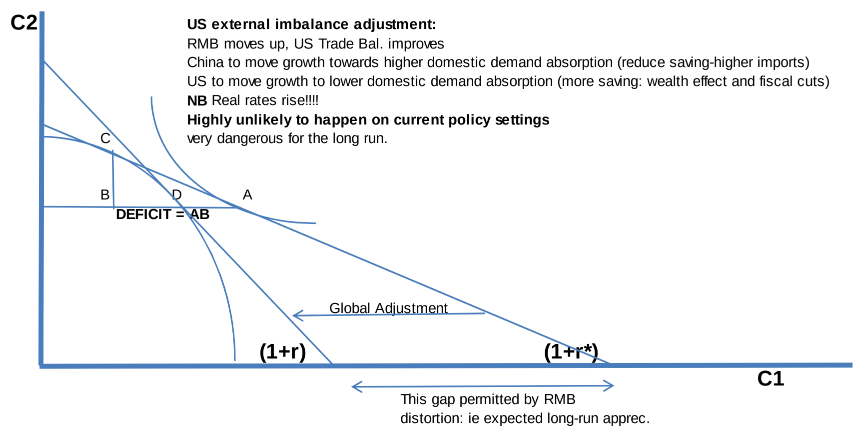
Source: Datastream, OECD

Fig. 6: US--China External Adjustment



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Source: OECD

Fig 7: Capital Regulations

- Banks are desperately short of capital—Basel II asks them to hold less.
- Basel Pillar 1 does not penalise concentration risk!!!! And relies on supervisors to do something in pillar 2!!
- Basel lets the regulated entities determine their own capital weights!!!
- Basel II does not allow for idiosyncratic or local risk (based on a single global risk factor).
- Weightings create regulatory arbitrage possibilities.
- A SIMPLE LEVERAGE RATIO IS SUPERIOR: BASED ON TOTAL ASSETS ON AND OFF BALANCE SHEET.

Fig 8: The Hypo Bank Quote

- By purchasing CDS protection on its assets, which remain on its balance sheet, Hypo transfers the credit risk to someone else, and this is recognised in its Basel risk-weighted assets. (As long contracts can be renewed—no global financial crisis).
- *"Since October 2007, DEPFA has been a member of the Hypo Real Estate Group, and this transaction achieves a number of objectives for DEPFA, and the Group as a whole: DEPFA has reduced the amount of regulatory capital required to support the assets (which under current BIS rules are 100% risk weighted, though under Basel II this will reduce substantially), and at the same time has improved the return on equity and credit risk"*

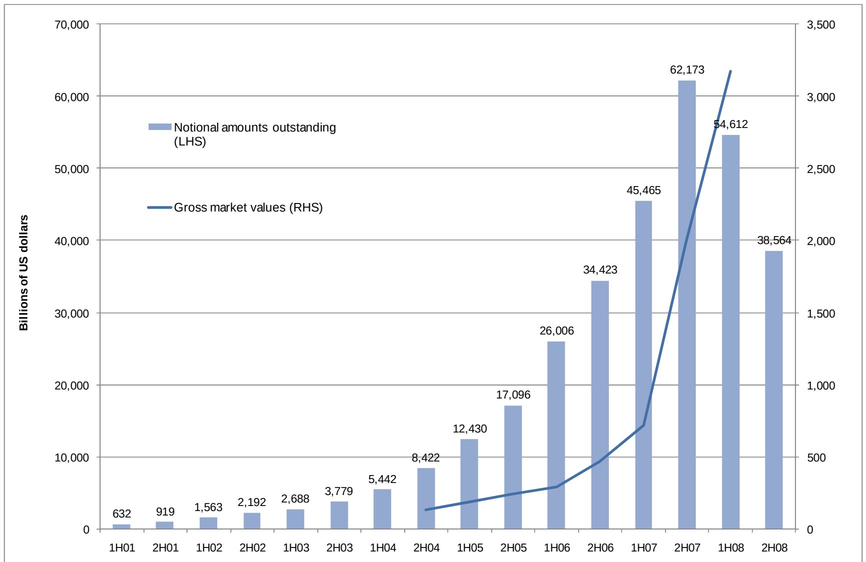
Fig 9: Northern Rock CEO & UK Treasury Committee Evidence

- Mr Fallon: "*Mr Applegarth, why was it decided a month after the first profit warning, as late as the end of July, to increase the dividend at the expense of the balance sheet?*"
- Mr Applegarth: "*Because we had just completed our Basel II two and a half year process and under that, and in consultation with the FSA, it meant that we had surplus capital and therefore that could be repatriated to shareholders through increasing the dividend.*"

Fig 10: The Tax Issue

- The tax system encourages securitisation.
- Tax haven opaqueness allows capital gains and income to be blurred in CDO creation
- Inequality of tax treatment of income and capital gains/losses causes CDS boom in synthetic CDO's.
- Debt versus equity bias pushes up leverage—double dipping deductions.

Fig. 11: The Explosion of CDS Contracts



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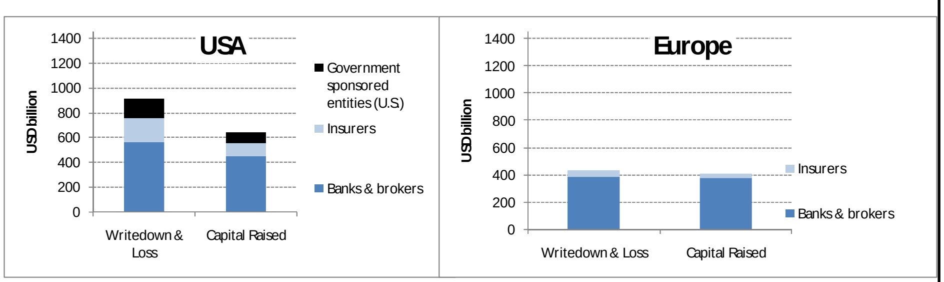
Source: BIS

Fig. 12: Losses, Capital Rebuilding



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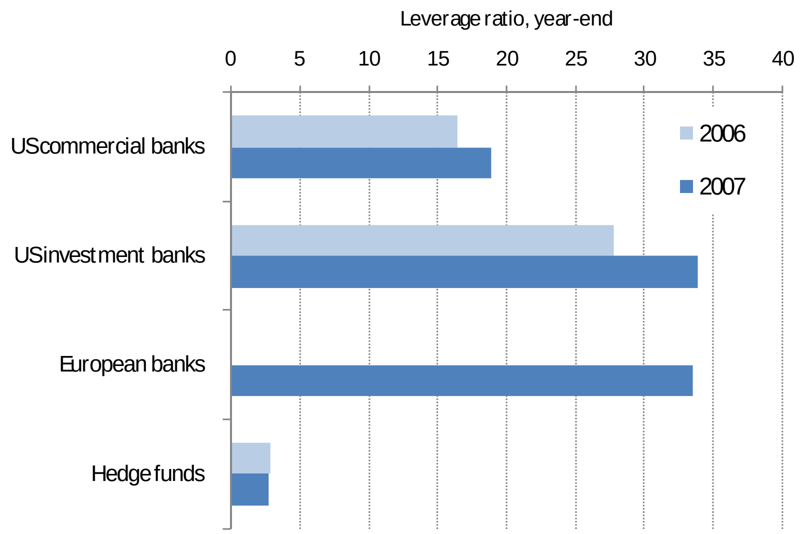
Source: Bloomberg

Fig. 13: Leverage Ratios Prior to the Crisis



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Source: Company reports

Fig. 14: USA (19 Banks) Losses, Capital Raised & SCAP Scenarios

(billions US dollars)	2007&2008	2009&2010 (Baseline)	Adverse Case 2009&2010
Capital end 2008	608.0		
Assets end 2008	10892.5		
Leverage Ratio	**17.9**		
Balance Sheet Writedowns	563.6		
SCAP consistent baseline Loss F/cast		361.3	599.2
Capital Raised	444.3	0	
Shortfall B/sheet	119.3	480.6	718.5
B/sheet cap needs (ex VIE's)		480.6	718.5
Off B/Sheet Exposures			
VIE's now consolidated onto B/Sheet (end 2008)	110.0		
VIE Outstanding (end 2008 unconsolidated)	796.3		
Unconsolidated VIE Loss exposure		389.4	389.4
Losses banks are responsible for (SCAP+VIE)	563.6	870.0	1107.9
Less earn. est. (see memo below)=CAP. NEED 2011		**434.0**	**781.9**
Years of Earnings		1.0	2.4
Memo items			
QSPE Outstanding end 2008	3192.4		1707.1
QSPE Loss est. (not a US bank Problem)*		567.0	
IMF forecast for all US bank losses	563.6	1040.4	1040.4
Und. Earn. @ 2% p.a. assets 2008 (& 1.5% adv. case)		436.0	326

*Using US SCAP assumptions for balance sheet losses

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Source: OECD, Company reports

Fig. 15: Europe (Loss Banks) Losses, Capital Raisings, & Scenarios

(billions US dollars)	2007&2008	2009&2010 (Baseline)	Adverse Case 2009&2010
Capital end 2008	1076.9		
Assets end 2008	39645.7		
Leverage ratio	**36.8**		
Balance Sheet Write Downs	436.1		
Capital Raised	399.9		
IMF B/Sheet Loss F/cast (Adv. Case = 5% assets)		300.9	1982.3
Shortfall on Balance Sheet	36.2	337.1	2018.5
Less earnings (see memo below)		**-445.9**	**1622.0**
Capital to get to the lower US leverage ratio			
Assets allowing for 5% growth		43709.4	43709.4
Capital Required for leverage ratio of 17.9 (USA)		2441.9	2441.9
Tot. Req. Capital (Assumes no Off B/Sheet Exp.)		1996.0	1996.0
Shortfall in capital for a 17.9 leverage ratio		**919.0**	**919.0**
Off Bal./Sheet Issuance + Share US QSPE's			
Tot. Eur. issuance of CSO's to 2009Q1 (book val.)	**2141.9**		
Share of US QSPE isssuance??	UNKNOWN	UNKNOWN	
Loss due to banks (Adv. case 0.48 of CSOs issued)	UNKNOWN	UNKNOWN	**1028.1**
Memo earnings @ 1% p.a. on assets end 2008 $793bn (0.5% Adv. Case)			

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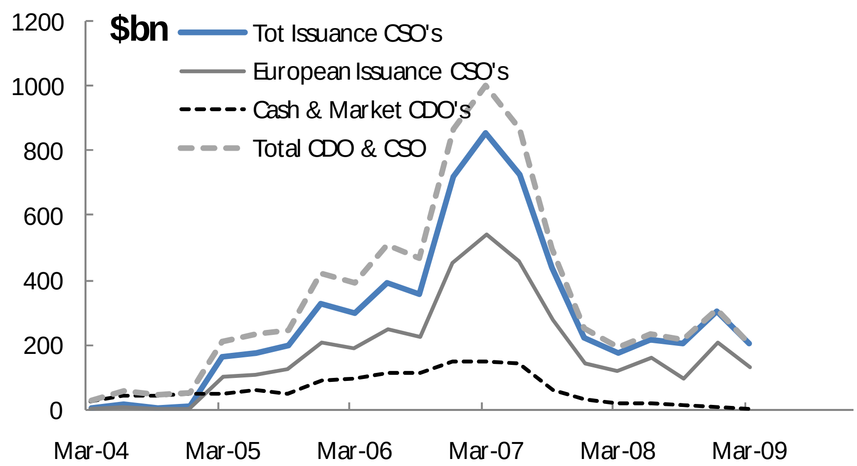
Source: OECD, Company reports and Bloomberg

Fig. 16: Synthetic CDO's & CLO's



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Source: Credit Flux

Fig. 17: $70.6bn Payments to AIG Counterparties ($45.7bn to EU!): Sept. 16 to 31 December 2008

(billions of US dollars)

Institution	Collateral postings for credit default swaps*	Payments to securities lending counterpaties**	Total	As a share of capital*** at end-2008
Goldman Sachs	8.1	4.8	12.9	29.1%
Societe Generale	11.0	0.9	11.9	28.9%
Deutsche Bank	5.4	6.4	11.9	37.4%
Barclays	1.5	7.0	8.5	20.0%
Merrill Lynch	4.9	1.9	6.8	77.4%
Bank of America	0.7	4.5	5.2	9.1%
UBS	3.3	1.7	5.0	25.2%
BNP Paribas	…	4.9	4.9	8.3%
HSBC	0.2	3.3	3.5	5.3%
[memo: Bank of America after its merger with Merrill Lynch]			12.0	*[18.1%]*

*Direct payments from AIG through end-2008 plus payments by Maiden Lane III, a financing entity established by AIG and the New York Federal Reserve Bank to purchase underlying securities.

**September 18-December 12, 2008.

***Common equity net of goodwill; net of all intangible assets for Merrill Lynch and HSBC.

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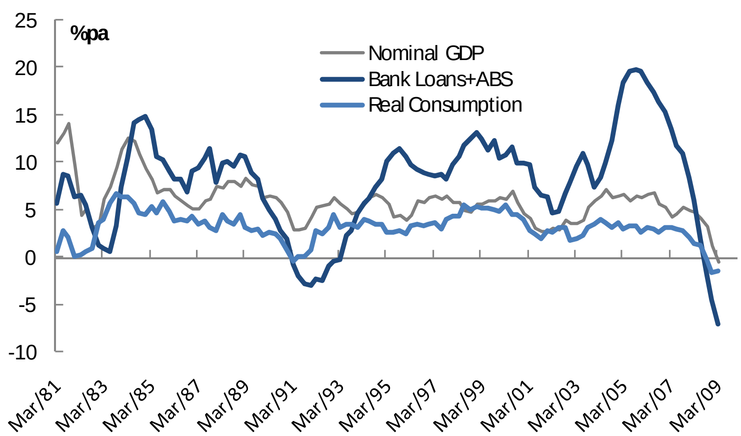
Source: Fed, US Treasury

Fig. 18: US Bank Intermediation (Bank Loans + ABS), GDP & Real Consumption



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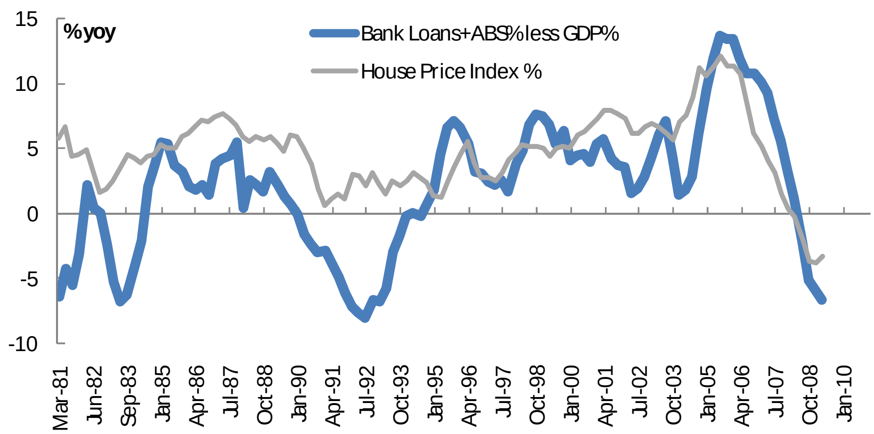
Source: Datastream, OECD

Fig. 19: US Bank Intermediation versus GDP % Change & US House Prices % Change



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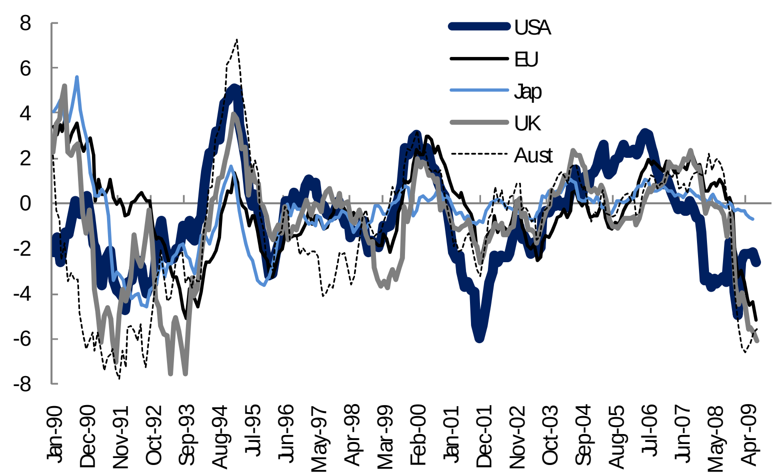
Source: Datastream, OECD

Fig. 20: Monetary Conditions Indexes: Pushing on a String?



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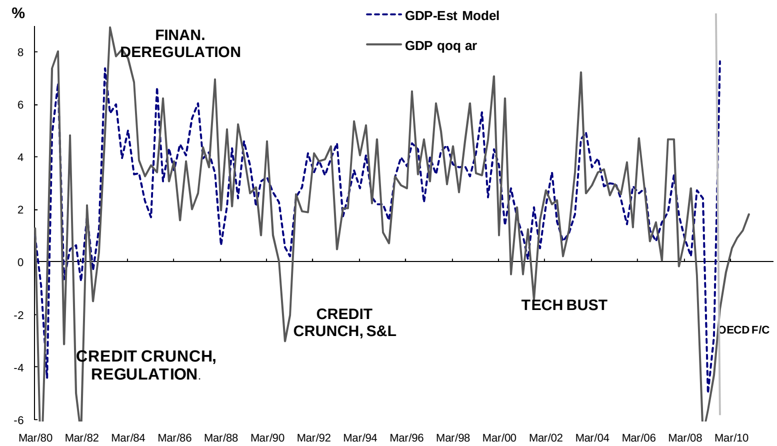
Source: Datastream, OECD

Fig. 21: US GDP, MCI Model of GDP, & OECD F/C GDP



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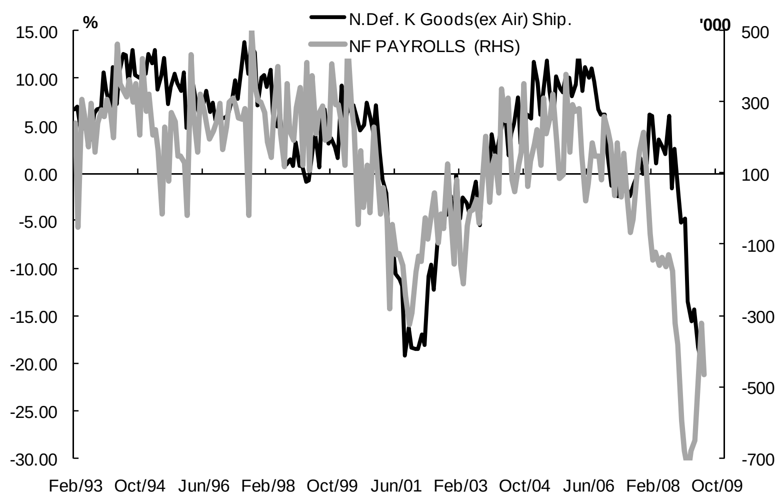
Source: Datastream, OECD

Fig. 22: Employment & Investment: What is Actually Happening?



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Source: Datastream, OECD

Fig. 23: Fiscal Deficit Projections

	2007	2008	2009	2010
	(per cent of nominal GDP)			
United States				
Financial balance	-2.9	-5.8	-10.2	-11.9
Gross financial liabilities	62.9	71.9	88.1	100.0
Japan				
Financial balance	-2.5	-2.6	-6.8	-8.4
Gross financial liabilities	167.1	172.1	186.2	197.3
Euro area				
Financial balance	-0.7	-1.8	-5.4	-7.0
Gross financial liabilities	71.2	71.0	77.7	84.4
OECD				
Financial balance	-1.4	-3.0	-7.2	-8.7
Gross financial liabilities	74.5	78.8	90.6	99.9

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Source: OECD

Fig. 24: Support Packages For Financial Sector

	Capital inject **(A)**	Purch. of assets and lending by Treasury **(B)**	Cen. Bank Supp. prov. With Trsy backing **(C)**	Liq. Provision & other supp. by central bank (a) **(D)**	Guarantees(b) **(E)**	**TOTAL A+B+C+D+E**	Up-front Govt. Fin. (c)
OECD members							
Australia	0	0.7	0	0	n.a.	0.7	0.7
Germany	3.8	0.4	0	0	18	22.2	3.7
Ireland	5.3	0	0	0	257	263	5.3
Japan	2.4	11.3	0	1.2	7.3	22.1	0.8(f)
Netherlands	3.4	2.8	0	0	33.7	39.8	6.2
South Korea	2.7	5.4	0	0.3	13.8	22.2	0.8(g)
Spain	0	4.6	0	0	18.3	22.8	4.6
Switzerland	1.1	0	0	10.9	0	12.1	1.1
United Kingdom	3.9	13.8	12.9	0	51.2	81.8	20.2(i)
United States	3.9	1.3	1.1	42.1	31.3	79.6	6.3(j)

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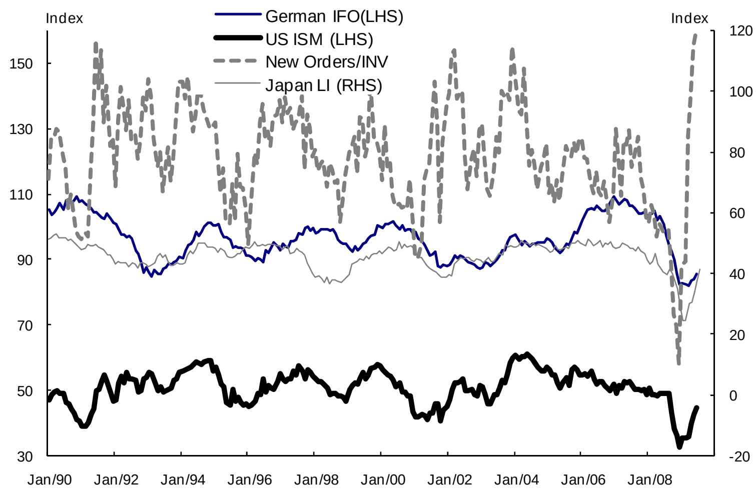
Source: OECD, IMF

Fig. 25: Global Lead Indicators: But Will Credit Stop the Inventory Cycle?



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Source: datastream, OECD

Fig 26: Why Is Australia Better Placed??

- Good Starting Point: Budget surplus, and high interest rates. Plenty of room to ease.
- China: Australia is vertically integrated into China, and China will decouple from the West to a large extent.
- 4 Pillars: Stable, medium-sized oligopolies that did not compete excessively in securities.
- Twin Peaks regulatory structure: APRA, ASIC. The RBA focus on monetary policy & stability of the payments system.
- Investment banking was at the core: Goldmans, Citi, JPM, Morgan Stanley, UBS take the lions share of the market here. But that is a US/European solvency problem.
- Macquarie: our one big IB introduced a Non-Operating Holding Company Structure (NOHC) in 2007. Reduces contagion risk amongst affiliates.

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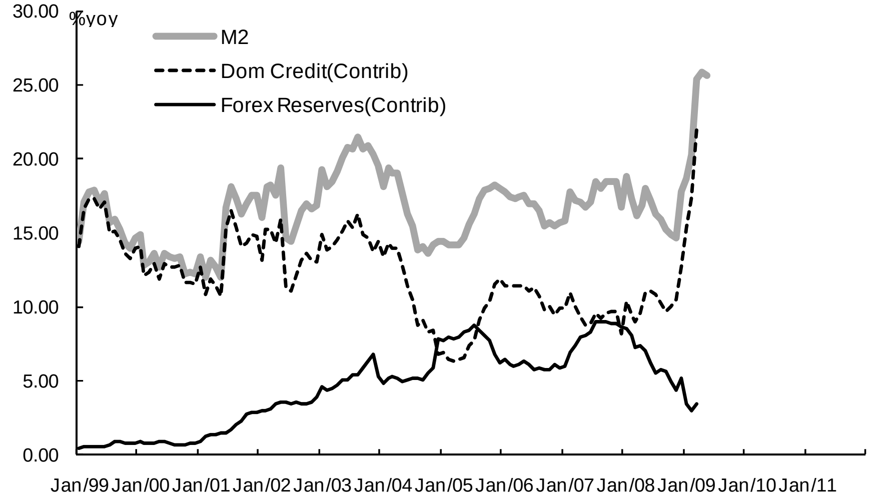
Fig. 27: China: Money vs Domestic Credit, Opposite of OECD Countries



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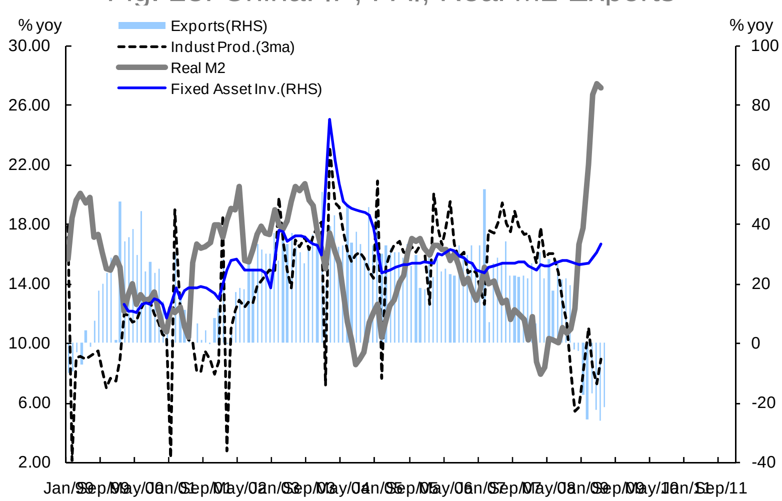
Source: Datastream, OECD

Fig. 28: China: IP, FAI, Real M2 Exports



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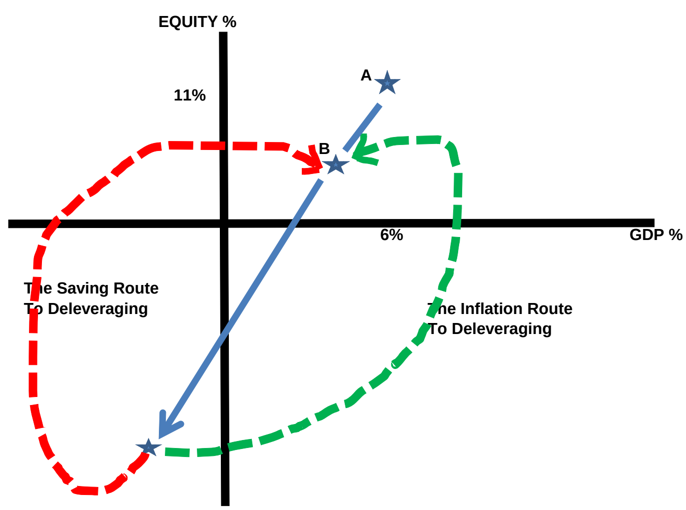
Source: Datastream, OECD

Fig 29: The Policy Agenda

- Macro/prudential:
- monetary reform—stop bubbles (carry trade already in action now!!).
- Guarantees (done).
- Deal with toxic assets (not done).
- Recapitalise banks (not done).
- Exit strategy, budgets, loans/guarantees, Reg. reform, monetary reform (all in front of us).
- Structural reform: Capital & Tax regulation: remove arbitrage opportunities (not done); Contagion risk reform (not done); Governance reform (not done); Pension reform (not done).

Fig. 30: Two Routes to Deleveraging



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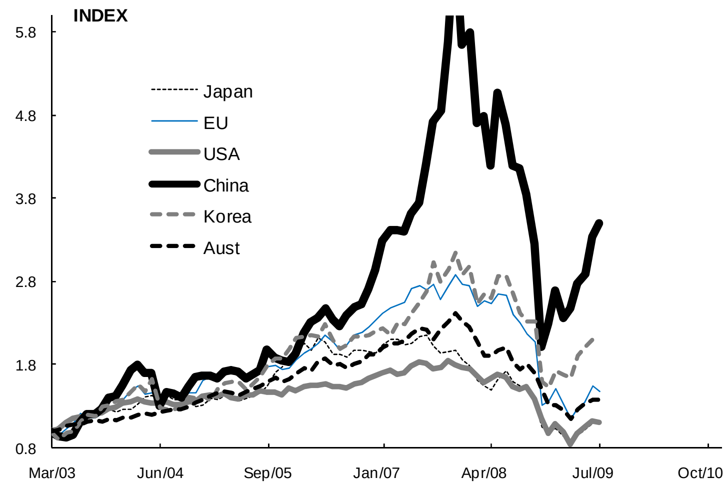
Source: OECD

Fig. 31: Stock Markets: Better EM Fundamentals?



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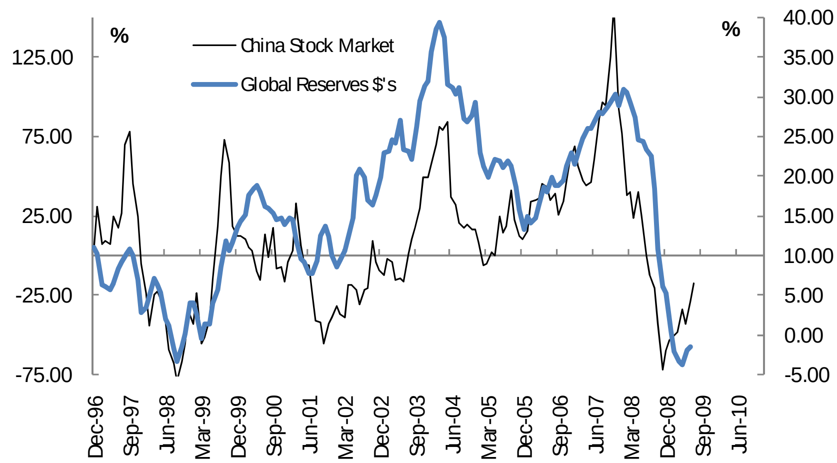
Source: Datastream, OECD

Fig. 32: Global Forex Reserves & China Stock Market



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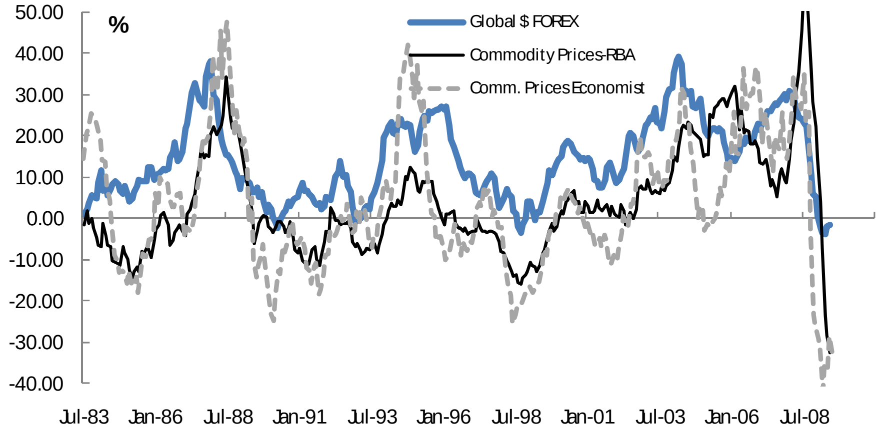
Source: Datastream, OECD

Fig. 33: Global Forex Reserves & Commodity Prices



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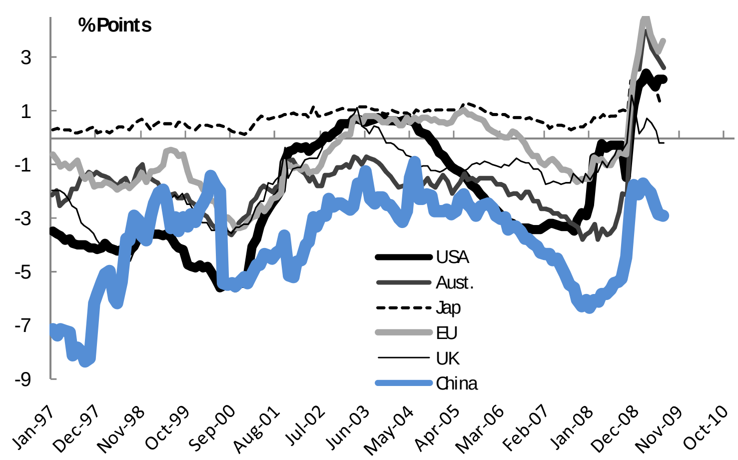
Source: Datastream, OECD

Fig. 34: Dividend Yield vs Cash



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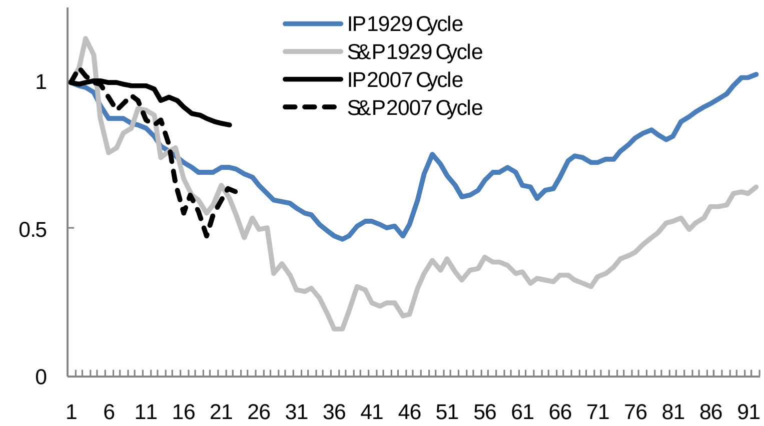
Source: Datastream, OECD

Fig. 35: 1929 versus Current Cycle: Equities, IP



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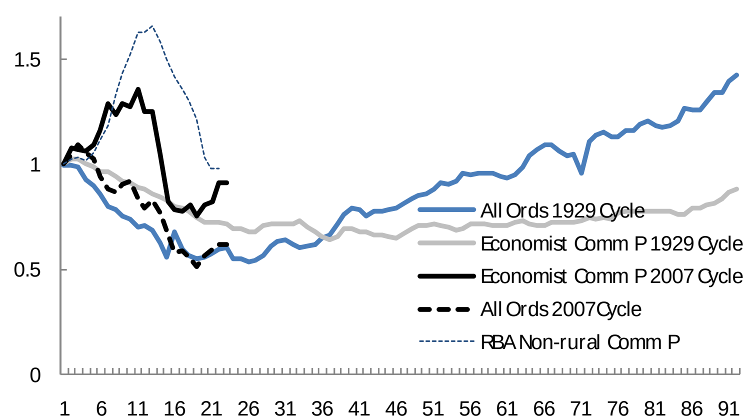
Source: Datastream, OECD

Fig. 36: 1929 versus Current Cycle: All Ords, Commodity Prices



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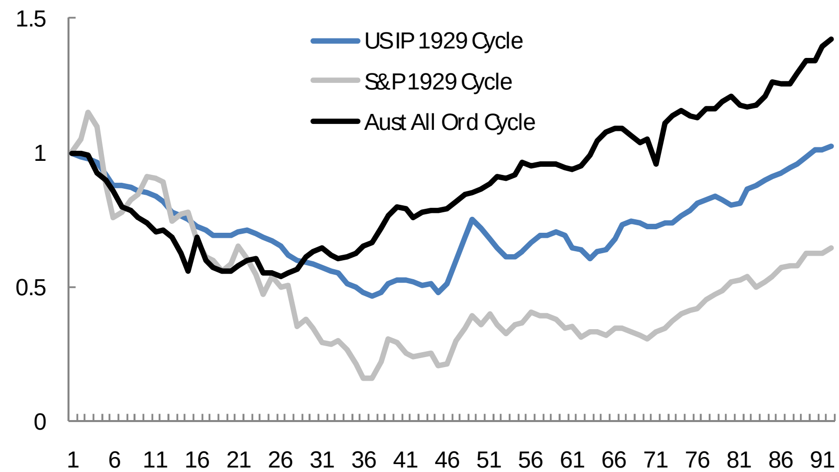
Source: Datastream, OECD

Fig. 37: 1929 Cycle: S&P versus All Ords



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Source: Datastream, OECD

Fig. 38: Anika Foundation Performance (Stocks of 20 held above 5 % weight: ORG 19%, BHP 15%, ORI 10%, MTS 9%, CBA 9%, CCL 6%)

ATTRIBUTION (ESTIMATES 100% EQUITY-Excl. Div)

PERIOD	Portfolio	ASX200
Since Inception (Dec 06)	-4.20	-19.61
12-month (Jun 09)	-14.30	-24.24
6-month(Jun 09)	3.67	6.64
3-month(Jun09)	9.50	10.41
Current Qtr (2jul 09)	0.77	1.16

Total Portfolio--Asset Allocation

Ann Perf.	% Equity	Perf Eq. %	Div	Div Yld	Int	Int Rate	Tot Perf %
Jun-07	29.56729						
Jun-08	19.70215	-11.425898	10824.34	5.261737	38398.25	7.835674	3.696301
Jun-09	15.45629	-14.300171	**9437.89**	5.289567	37454.06	5.150553	2.360501
YTD(Jul 16/Jun09)	14.28908	0.77321891	752.72	0.42187	0	0	0.170767

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Source: Datastream, OECD

Fig 39: Bad Bank Approaches

- AM approach, (US PPIP): Advantages: quick; uses market skills in pricing & managing; shares taxpayer risks with private sector; open market approach=level playing field.
- Swiss approach: Government "bad bank" for UBS toxic assets; plus partial nationalisation. Disadvantages: taxpayers take all the risk, and no level playing field.
- UK Approach: ring fence the bad assets on the balance sheet, and guarantee them. Disadvantages: same as Swiss approach.
- Mergers: Bank of America takes Merrill's, Lloyds takes HBOS, Wells takes Wachovia. AHEM!! 2 turkeys don't make an eagle—no new net capital, and systemic size rises.

Fig 40: Equity Culture, & Competition vs Prudence

- Equity culture—fee driven earnings and the driving the share price, with benefit from bonus remuneration.
- "Too big to fail" is a huge problem—moral hazard in risk taking (bank lending/underwriting and by investors/depositors).
- "Too big to fail" problems come out of merger policy and what you allow banks to do—such as own investment banks and permit massive leverage on the balance sheet.
- Australian banks are in the top 10. Why? 4 pillars policy, they don't do investment banking and they had profitable lending opportunities driving funding (not the other way round).
- You need profitable lending opportunities, not raise deposits and debt to search for fee-driven, regulatory and tax arbitrage to push up bank share prices.

Fig 41: Competition Policies

- Open market buying of toxic assets is least distortive;
- Foreign acquisition of domestic weak banks fosters better competition.
- Selling asset of failed firm in pieces enhance competition.
- Temporary nationalisation is better than a megamerger.
- Promote entry with competitive mergers of smaller healthy banks—e.g. regionals—in overbanked jurisdictions. They are ready to lend and competition will force recapitalised banks to lend.
- Foster removal of regulatory barriers to entry: fine grained credit rating information on consumers and small businesses; 'switching packs to reduce customer inertia; remove regulatory barriers.
- NOHC structures to foster transparency, competition, and regulatory ease.

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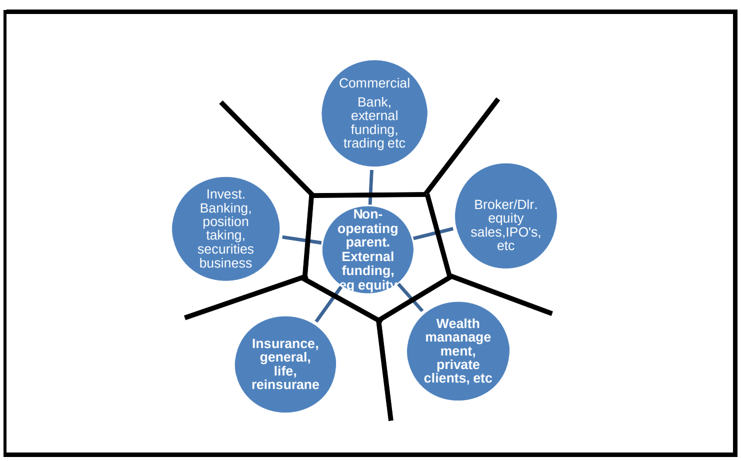
Fig. 42: Non-operating Holding Company NOHC



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Source: OECD

Fig 43: Corporate Governance

- Independent directors: strengthen fit and proper person test to cover competence, technical expertise. Risk management skills; formal separation of CEO and Chair; term limit on board membership.
- Risk officer role with access to the board (with special employment terms--CEO doesn't fire or set salary).
- Fiduciary responsibility of directors: clarified tying duties to single affiliate in the case of complex firms.
- Remuneration: board reform helps, and tax incentives provide teeth.

Fig 44: Pension reform

- No tapping public pension reserve funds.
- Strengthen confidence in private pension systems—no reversion to public dominance.
- Crisis forbearance over funding should be temporary.
- Strengthen pension fund governance—fit and proper persons with expertise.
- Consolidate small pension funds.
- Reconsider regulations that aggravate selling in the crisis—countercyclical funding rules.
- Hybrid pension arrangements to reduce risk as pressure mounts on DC schemes: promote DC with lifetime target returns and indexation features when solvency permits.
- More choice in accumulation and retirement stages: conversion rules for annuities; default asset allocations ; i.e. to ease timing risks and new pressures from the crisis (need to work longer etc).
- Strengthen financial education.