



Preserving financial stability: the subprime crisis and financial supervision

CARLOS ARENILLAS LORENTE, VICE- CHAIRMAN OF THE CNMV

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Introduction

I am grateful for this opportunity to participate again in the summer course at the UIMP organised by APIE, which has long been directed, with considerable success, by Miguel A. Noceda and Ángel Boixadós. It is an event which attracts dozens of attendees to Santander each year, most of them students or professionals of communication in the area of economics and finance, together with leading figures in our country's economy and financial sector.

The central theme of the course this year is the internationalisation of Spanish business. Therefore, and considering the financial turbulence we are currently experiencing, I have decided to focus on financial stability and the international architecture of financial supervision.

Firstly, I will discuss the importance of financial stability in a globalised financial system. I will then briefly cover the subprime crisis, noting the most salient features and lessons, specifically those relating to supervisors and regulators and, more specifically, to a market supervisor such as the CNMV. I will conclude that, in order to preserve financial stability, it is essential to ensure an appropriate architecture of financial supervision and I will argue for a twin supervisor model (referred to as "twin peaks") based on the coexistence of a solvency supervisor (i.e. prudential supervision) and another supervisor that oversees conduct in the markets and relations with clients.

These subjects are extensive and my time is limited; accordingly, I will summarise, even at the risk of oversimplification. Nevertheless, I hope to give a clear picture of the fundamental aspects of these issues.

I have given the organisers a number of documents related to my lecture, which I recommend as additional reading when you have the opportunity. Most notable among them is the report by the Financial Stability Forum, a key document for understanding the diagnosis and measures envisaged by the key multilateral public agencies in the financial arena to respond to the subprime crisis. In recent months, the CNMV has assisted in much of the work done in this area.

As is customary in this venue, I will take questions when I conclude.

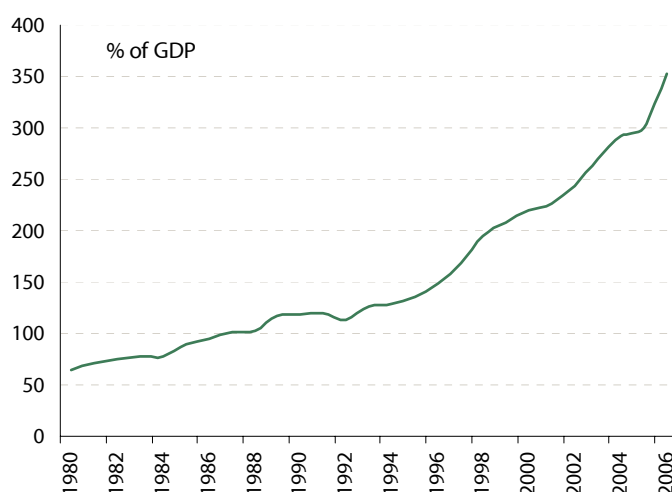
1. Financial market internationalisation and financial stability

The financial markets have experienced a radical change in the last three decades, coupled with rapid expansion as a result of deregulation, innovation and globalisation together with progress in information and communication technologies. International capital flows have

multiplied, markets in numerous new and sophisticated financial instruments have arisen, and the ease and speed with which financial transactions can be concluded has increased notably.

One datum that illustrates this increase in financial activity in the world economy is the sharp growth in foreign assets and liabilities in the advanced economies¹, risen from just over 50% of GDP in 1980 to over 350% at present.

Indicator of financial globalization
Gross foreign assets and liabilities in the advanced economies



Source: IMF

Although these changes have been beneficial overall and have led to a more efficient distribution of capital, they have often been accompanied by notable perturbations in the market. Let me give some examples: the savings and loan crisis in the US and Japan's major financial crisis in the late 1980s; Black Monday in the US in 1987; the turbulence in the G-10 countries' bond markets in 1994; the crisis in Mexico (1994-95); the crisis in South-east Asia (1997) and Russia (1998); the collapse of hedge fund Long Term Capital Management in 1998; Argentina's bankruptcy in 1999; the exchange rate fluctuations during the 1990s; the bursting of the tech bubble and the accounting scandals in the stock markets in 2000 and 2001. I will discuss the most recent crisis, which is unlikely to be the last, in the second half of my lecture.

Volatility and occasional periods of turbulence and stress are inseparable—and perhaps necessary—features of the financial markets, since they enable valuations to be adjusted to fundamentals and make it possible for investment decisions to be based on a proper perception of risk. However, some of the aforementioned episodes led to a temporary interruption in the proper working of the financial system as a whole, thus perturbing the financing of the economy and leading to very adverse macroeconomic effects. As a result, these developments have highlighted the fact that maintaining financial stability deserves to be a goal of financial policy in its own right.

¹ Gross foreign assets and liabilities include debt and shares. The advanced economies are: Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Malta, the Netherlands, New Zealand, Norway, Portugal, Singapore, Slovenia, Spain, Sweden, Switzerland, Taiwan, the UK and the USA.

The international financial system has become so complex that identifying and evaluating risks is a growing (and ever-costlier) challenge to the authorities. Instruments are needed to provide clearer and earlier warnings about imbalances that are developing.

But, what is meant by financial stability in this new framework? Financial stability can be viewed as a public good; therefore, its maintenance requires intervention by supervisors and regulators. Supervisors must seek to prevent crises, but without hampering the process of natural selection of a market economy. That is, there should be mechanisms to ensure that players assume the economic and reputational consequences of their errors or misdeeds, while minimising the impact on the system as a whole.

The old idea that financial stability depended solely on bank solvency has been discarded. The concept of financial stability has been expanded to recognise the financial system's diversity and complexity and the importance of codes of conduct and transparency on the part of issuers, intermediaries and investors, as well as discipline in the financial markets, for preserving financial stability. Additionally, the proliferation of new financial institutions—what some analysts call the parallel financial system: private equity, hedge funds, etc.—makes it advisable to expand regulation and supervision to cover players of this type since their size or presence in a range of financial markets means that they match the traditional financial institutions in importance.

This expansion of the concept of financial stability is evident in the definition adopted by Spain's Comité de Estabilidad Financiera (CESFI), which comprises the CNMV, the Directorate-General of the Treasury, the Bank of Spain and the Directorate-General of Insurance, and is chaired by the Deputy Minister of the Economy. The committee was created in 2006 by means of a cooperation agreement signed by its constituents. The definition of financial stability adopted by the CESFI is basically as follows²:

“Financial stability can be defined as a situation in which the financial system eases the proper functioning of the economy through the transfer of funds from savers to investors, the provision of financial services to the overall economy, the execution of payments and the distribution of risk among economical agents in an organised and efficient way.

Therefore, besides an adequate legal framework and regulatory and supervisory structure, financial stability requires a proper functioning of financial institutions (credit entities, insurance companies and investment entities, among others), of financial markets (equities, bonds, currencies, derivatives, among others) and the operational infrastructures (payment, trading, clearing and settlement systems) that support them, so the overall financial system can face unexpected shocks without jeopardizing the above mentioned functions.

Depository entities play a crucial role in the stability of the financial system because of their key role in the funds transfer process from depositaries to investors (companies, families and governments), through credit and bank deposits markets, in the payments system (wholesale and retail ones) and in risks management and transformation (credit, liquidity, market and operational risks among others).

Securities markets also have an especially relevant function because, due to the last years intense process of financial disintermediation, they have achieved high development and maturity. They have made possible a direct resources transfer from savers to investors thanks to the emergence of new financial intermediaries, to the transformation of some others and to the development of multiple financial instruments”.

² The above translation has been made by the Comisión Nacional del Mercado de Valores.

This definition is similar to the one proposed by Schinasi³ in a publication by the International Monetary Fund. A financial system is stable if it: firstly, facilitates the effective assignment of economic resources; secondly, values, assigns and manages financial risks; and, thirdly, maintains the ability to perform these essential functions in the face of external shocks or an increase in imbalances.

Apart from the need to focus on the financial stability problem from a broad perspective, covering all markets and intermediaries, the recent episodes of turbulence have shown that the mechanisms by which perturbations are propagated internationally are also relevant. For that reason, any initiative to strengthen the system that does not fully acknowledge the globalisation of financial activity, its complexity and diversity, beyond the simple divisions between banking, insurance and securities, is doomed to failure.

Fortunately, lessons have been learned from each crisis and period of instability, and the mechanisms for preventing and managing them from a global perspective have been strengthened.

For example, the Financial Stability Forum (FSF) was created in 1999 in order to promote information exchange and international cooperation in the area of financial supervision. The Forum's members include national authorities (unfortunately, Spain is not represented directly) as well as international organisations such as the IMF, the World Bank, the OECD, the ECB, the IASB (which issues the International Financial Reporting Standards), IOSCO (the international organization of securities commissions) and the Basel Committee (the banking counterpart of IOSCO). The FSF seeks to coordinate the efforts of all these bodies to promote international financial stability, improve market efficiency and reduce systemic risk. The FSF played a key role in responding to the subprime crisis, as I will discuss later.

With a view to preserving financial stability, there have been normative or supervisory initiatives in recent years that take a broad view of the financial system; that is to say, they acknowledge the importance of international standardisation. There have been many international efforts to equip the financial system with common standards for efficient performance in a globalised world. They include most notably the following: the development of an international accounting language (the IFRS), the drafting of international auditing standards, and the new Basel Accord on capital requirements for financial institutions.

In the specific area of the European Union, there has been intense progress in the convergence of financial regulation, as evidenced by the various directives that harmonise the rules governing Europe's financial markets. Also, the strengthening of mechanisms for cooperation between financial authorities is epitomised by the fact that 118 EU supervisors and regulators have signed the MoU between financial supervisors (i.e. of banking, securities and insurance), central banks, and finance ministries in the field of cross-border financial stability. The MoU came into force on 1 June 2008.

I think I can conclude this first part of my lecture by stating that, over the last few decades, as the financial system has grown in sophistication in the context of globalisation, the idea of financial stability has gained simultaneously in importance and complexity. The recent turbulence has evidenced the need for financial regulators and supervisors to work in a coordinated manner in order to strengthen the stability of the global financial system, a

³ The IMF document to which I refer, which is very educational and written in non-technical language, is included in the documentation I have supplied

challenge which the authorities are addressing but which will require even greater efforts in the future.

I will now discuss the subprime crisis.

2. The subprime crisis and the authorities' response

The subprime crisis is a phenomenon that commenced early in 2007 and intensified towards the middle of the year, when delinquency rates on subprime (i.e. high-risk) mortgages in the USA increased considerably. What began as a localised phenomenon subsequently acquired a global dimension, affecting the world's financial markets and, ultimately, the way in which the economy is funded.

These mortgages had been granted in a context of low interest rates, leading to a reduction in the lenders' unit spreads. The narrower spread encouraged lenders to increase the number of transactions and to lend to riskier borrowers in a period, from 2003 to 2006, in which the price of risk was at a record low.

This fact, coupled with easy access to finance and a model of banking regulation in the US and other countries that allowed the originator of credit risks to shed them entirely, resulted in those risks being undervalued and dispersed quite opaquely in the form of structured products through the world's financial system. The subprime mortgages were part of the packages of bank assets sold by the originators to special purpose vehicles, which financed the purchase by issuing securities backed by the assets thus acquired. The securities were purchased by institutional investors worldwide and by other vehicles which repackaged them in turn and issued securities with a higher rating, thus further complicating the spread of these toxic products.

There was a range of resulting effects: they include a loss in the value of the mortgage-backed securities (with the resulting losses for institutions that had invested in them) and a loss of confidence in these very complex instruments and in the institutions that had issued them or that held them on their balance sheets. The subprime crisis also had a knock-on effect on markets in instruments that were unrelated to the US subprime mortgage market, and it had an impact on the funding capacities of institutions with little or no subprime exposure. That is, there was a spillover effect.

Perhaps the most novel development in this crisis, compared with previous crises, was the sharp reduction in transactions and, therefore, in liquidity in the various wholesale primary and secondary markets. That is, it impaired the working of the pricing mechanism as a fundamental mechanism for discriminating between issuers of different quality. The result was a perturbation of the volume of funds raised by financial institutions and, therefore, of the proper workings of the mechanisms for funding the economy. The liquidity problems arose in markets that are normally relatively inactive, such as the structured products market, as well as in others that are normally very liquid, such as the interbank market.

The combination of effects was aggravated by an excess of leverage, i.e. the excessive accumulation of debt in the financial system in the last few years.

The result was a sharp reappraisal of risk and prices, leading to a contraction of credit worldwide which made it necessary for the monetary authorities to respond.

That response, which ranged from liquidity injections into the interbank markets to the adoption of looser monetary policies in some countries, has nevertheless proved insufficient so far to fully restore normality in the markets. In this context, a number of institutions experienced acute liquidity problems which affected their solvency in some cases.

These problems in the financial markets had a range of adverse macroeconomic effects, particularly on the supply of credit. In particular, GDP growth rates were reduced and the prospects of economic growth in the next two years have also deteriorated. These contractionary effects were exacerbated by the inflationary pressures driven by the sharp increase in the price of commodities, especially oil and foods.

As I have mentioned, the broad global effects of the subprime crisis are closely linked to a loss of confidence, which evidences that there is insufficient transparency in several areas of the financial system.

This transparency deficit manifests itself in three specific aspects:

- insufficient or unclear financial information about the market players.
- insufficient or unclear information about the nature of the products exchanged; for example, complex structured products.
- insufficient or unclear information about how, when and at what price products are being traded in the market.

The transparency deficit's impact has been exacerbated by the doubts about the actions of the rating agencies, to the extent that they translate financial information into the language of decision-making.

In this context, there has been very rich international debate and numerous international bodies, both public and private, have produced research and recommendations on this issue. Because of its importance, I think the document produced by the Financial Stability Forum in April merits particular attention. The report was in response to a commission from the G7 and was a collaborative effort by the organisations comprising the Forum, although the private sector was also consulted. The CNMV participated actively through IOSCO⁴.

The 67 recommendations published by the Financial Stability Forum in April can be grouped into five major areas or blocks:

1. Strengthen prudential oversight of capital, liquidity and risk management.
2. Improve the transparency of markets, products and valuations.
3. Seek changes in the role and use of credit ratings.
4. Strengthen the authorities' sensitivity to risks.
5. Establish robust agreements for managing tensions in the financial system.

These recommendations, which should be implemented by national financial supervisors and regulators, international bodies (such as IOSCO, the Basel Committee, and IASB, etc.) and financial institutions themselves, are a very useful starting point for correcting the deficiencies observed in the workings of the global financial system.

I would emphasise that a large number of the recommendations deal with questions of transparency and codes of conduct and with the need to enhance cooperation for the purposes of financial stability. That leads me into the third and last section of my talk.

⁴ The documentation which I have supplied includes both the FSF report and the report on the subprime crisis drafted by a special working group at IOSCO in which the CNMV participated, and which was one of the inputs into the FSF's final report.

3. Relevance of the architecture of financial supervision

I will now tie together two of the issues discussed earlier, namely the importance of financial stability in a global world and the lessons we are now taking from the subprime crisis, in order to make some comments on the importance of the supervision architecture for preserving financial stability.

We concluded earlier that financial stability, as a goal of public policy, should be construed in a broad sense to include not only the solidity of financial institutions' capital but also the proper assignment of resources in the various markets. In fact, as we have seen, the subprime crisis jeopardised global financial stability mainly as a result of objective deficiencies in the working of the markets, such as a lack of transparency about issuers, products and the terms of the transactions, and deficient performance by the rating agencies. Therefore, for any model of organisation for supervision to be effective, it should devote sufficient attention not just to the solvency of institutions but also to the behaviour of market participants, on which market efficiency depends.

In the developed world, we observe a range of models of financial supervision which can be divided basically into three types:

Firstly, the traditional model of sector supervisors, in which there is a separate body in charge of full supervision of each of the main financial sectors: credit institutions, insurance and securities. In this model, banking supervision is normally assigned to the central bank. I consider this model to be outdated since the borders between these three areas of financial activity are becoming increasingly complex and diffuse. Moreover, each supervisor maintains its own list of priorities with regard to prudential and conduct matters within its sector, which may result in either area receiving insufficient attention.

Another approach is to have a single regulator for the financial sector; this is the case of Germany and the United Kingdom. In this model, a single institution—which is not the central bank—is in charge of overseeing all financial institutions' solvency and compliance with the rules of conduct. This approach should lead to an efficient use of supervisory resources by taking advantage of synergy in overseeing the various activities of a given entity. However, some recent cases in countries with a single supervisor illustrate the difficulties that may arise in this model in the coordination between the central bank, which manages the system's liquidity, and the supervisor. Finally, as in the case of sectoral supervision, this approach leads to the establishment of a hierarchy between the prudential function and the conduct function, which may not always coincide with what is desirable from a social standpoint.

The third model distributes functions on the basis of objectives: the so called "twin peaks" model, adopted by The Netherlands, Australia and Italy, and may be on the cards for the USA, to judge from the plans of the current administration. In the twin peaks approach, the supervisory functions are assigned to two separate but appropriately coordinated institutions. One of them is in charge of compliance with the rules of conduct by the participants in all the financial markets; the other, which is normally the central bank, oversees the solvency of all relevant financial institutions, regardless of whether or not they have a bank charter. This model guarantees proper coordination between liquidity management and prudential supervision since both functions are handled by the central bank. Moreover, and this may be its main virtue, the twin peaks model ensures that proper attention is given to the two matters that are vital to the preservation of the financial system's stability: namely, financial institutions' solidity in terms of capital, and the proper functioning of the markets in financial products and services.

Spain's approach is basically sectorial, with three financial supervisors: the Bank of Spain, the CNMV, and the Directorate-General of Insurance and Pension Funds. It is therefore good news that the Deputy Prime Minister recently announced plans in this legislature to change the supervisory model, moving clearly towards a distribution of functions on the basis of objectives. The CNMV has been calling for such a move for some time, and it is also supported by the Bank of Spain.

4. Conclusions

I will conclude with a brief summary of the points I have made.

The financial history of the last 30 years has a number of clear characteristics: growing globalisation and sophistication in the financial markets. These features have led to substantial changes in the behaviour patterns of issuers, intermediaries and investors, and in the range of products on offer. At the same time, the development of the markets has made the work of financial supervisors more complex. Consequently, although markets have become more efficient, the successive episodes of turbulence and crisis throughout the world in recent years have brought to light a number of notable deficiencies. Those episodes, though differing in nature, reveal a common pattern: for example, their impact is increasingly felt throughout the world, affecting a growing number of regions and markets and often significantly impairing economic growth and employment.

In this context, the relatively recent concept of financial stability has been modified gradually to reflect the growing complexity of the financial system by adding the concept of proper market functioning to the traditional component of bank solvency. At the same time, the goal of financial stability thus defined has been gaining in importance in the framework of public policy.

The architecture of the supervision system would appear to be vital to success in maintaining financial stability. Without a model of supervision that is responsive to the current financial system, which is more complex and global, we will depart from that public goal and will fail to take full advantage of the positive effects of a more competitive, efficient financial system. Since the old models of sectorial supervision (banking, insurance and securities) have become obsolete, a sole supervisor or twin peaks are the two options around which countries are adapting their structures. Spain is moving towards the twin peaks option, which I consider to be the one best suited to this country's situation.

In any case, regardless of the supervision model that a country chooses, the current turbulence has shown that financial stability can only be maintained with determined international cooperation. In my opinion, this will enable the multilateral institutions to gain in importance in the immediate future. It is also advisable for countries to converge their systems of organising supervision in order to better align their objectives and practices and thus favour better coordination.

I will conclude with a final reflection.

As we have seen, the world's financial system has faced many financial crises. We have had two significant ones so far in the 21st century: the crisis or turbulence in 2000-2003, and the current episode. The first episode taught important lessons that led to an improvement in the workings of the financial system, though they were not enough to avoid the recent turbulence; nevertheless, it is worth noting that before 2007 many bodies issued warnings, in a number of public reports, about the risks building up in the financial system; regrettably, those warnings went relatively unheeded.

However, just as the first episode was surmounted relatively quickly, we can expect that the same will occur in the present case, based on the lessons learned, and that we will avoid a prolonged recession. I am moderately optimistic. I agree with those who think that the worst of the crisis in the financial sector has passed, although its adverse macroeconomic effects may be felt for some time.

I am convinced that the international and national financial authorities are conducting a rigorous analysis of the causes of this crisis; in fact, a number of specific proposals for action have already emerged. I am sure that the measures to be adopted will not only hasten the end of the crisis but also reduce the likelihood of similar episodes in the future and, therefore, will contribute to maintaining that public good: financial stability.

Thank you very much for your attention; I will be happy to answer any questions.