

Issue

5

OCTOBER 2008

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Fifth Issue



# IAFEI Quarterly

*The electronic professional journal of IAFEI  
(International Association of Financial Executives Institute)*

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October 2, 2008

## Letter of the Chairman

Dear Financial Executive,

You herewith receive the **Fifth IAFEI Quarterly**, which is the electronic professional journal of IAFEI. The journal is the internal information tool of our association, destined to reach the desk of each financial executive, who is a member of a national IAFEI member institute. This is, what the supporters of the project at IAFEI do want the IAFEI Quarterly to be.

**Several IAFEI member institutes have again contributed to this issue with own articles**, among them a first contribution from the Belgian member institute.

Let me repeat, that I encourage all the other IAFEI member institutes as well, which have not yet contributed articles, so far, to this journal, to do so, from time to time, from hereon. We would like to get as broad a base, of input, from within IAFEI, as possible.

This electronic professional journal of IAFEI is meant to be *your* IAFEI Quarterly. The individual national member institutes of financial executives are the heart and the backbone of IAFEI. IAFEI itself has not an organization of its own, due to the smallness of its financial means, a concept, which our founding fathers have so designed, and to which all present IAFEI member institutes continue to adhere. As a consequence, IAFEI does depend on the voluntary input of professional articles from its IAFEI member institutes, to this journal.

With due realism and self criticism, it is necessary to again state: There is still plenty of room, for the IAFEI Quarterly, for change and for improvement, now and in the future. Your comments, opinions, and suggestions for improvements will each be carefully considered and put into practice if feasible within our resources. We continue, to remain open to change for improvement.

In the past quarter, the new **IAFEI Task Force Rating** has vigorously started its work. The subject of rating continues to get high attention at all interested parties, including the financial executives, regardless as to from which country's point of view the subject is being observed.

The **Asia Pacific IAFEI CFO Summit**, in Taipei, Chinese Taiwan, on September 5<sup>th</sup>, 2008, was well attended by participants from Asia, and by some from Europe as well. The broad spectrum of subjects was well received, and networking among financial executives was enhanced.

The **financial crisis** emanating from the USA has continued during the last quarter, and has particularly exacerbated during September. This financial crisis is now spreading into much of Europe, and to a lesser, but still noticeable, extent also to Asia. In all countries we feel the effects of this financial crisis. As bad, as the crisis has become by now, we also do now see that governments, central banks, supervisory agencies, and the financial industry itself, are working consciously and

eagerly, in order to stabilize the financial system and to contain, as much as possible, the spreading of the financial crisis into the real economy. While all of us are impacted by these turbulences, it is encouraging to see that relentless efforts are on their way around the globe to stabilize the financial system and learn the right lessons from the aberrations. Let us all therefore be confident, that this crisis will be overcome. Let us all financial executives continue to act, in this environment, with caution, composure and circumspection.

Last but not least, in **Paris, France**, on December 14 – 17, 2008, the **XXXIX IAFEI World Congress** will be held. Do not miss this IAFEI highlight of 2008. Our member institute DFCG, the financial executives institute of France, is organizing this 2008 world event of IAFEI and is offering a broad and rewarding professional program. DFCG and IAFEI will be happy, to see as many of you, as possible, at this congress.

With best personal regards

Your Chairman IAFEI

Helmut Schnabel

## **Sovereign Ratings: Pushed up by Boom, Pulled down by Bubble**

**Author: Louis de Fauconval,  
Fortis – Economic Department & Country Limits**

Eighteen months ago, central banks of the major currency zones felt trapped between the need of fighting price instability and the temptation to give their economies some fresh air. Unit Labour costs in the US were growing excessively, monetary creation was too quick in the Eurozone, translating a rapid growth of credit to the private sector, while in Japan, inflation proved negative. US Federal Reserve (Fed), European Central Bank (ECB) and Bank of Japan (BoJ) were stuck with their interest rates, but early warnings of a big confidence stress were heard, and with them appeared the first temptations of easing monetary conditions. Then the Subprime stormed in (in August 07) and central banks engaged on divergent paths, the Fed on the way of softer interest rates, the ECB and Japan staying on their positions.

Do we stick to the official definition of a recession? Then we have to admit that the American activity hasn't entered such a period, *yet*, in any case, since its expansion has not been negative during two consecutive quarters. Sustained by rising inventories, cheaper exports, and a fiscal package, the US GDP has even posted a positive growth rate in the first half of 2008. But the story is not over: inventories built during Q1 have to be sold. And consumers – especially those who left the job market (the unemployment rate is now above 6%) will sulk retailers in the ongoing H2, industries will have to wait another period before producing to refill warehouses. Should this scenario materialise, those who are of the opinion that the Sub prime crisis finally will push the economy in negative ground will be right, at the end. Unless successive monetary policy actions implemented by the Fed and the US Treasury since August 2007 prove sufficient to limit immediate damages to their today's level and help restore confidence? Chances for such a scenario are tiny, and M. Bernanke knows it.

### **Suddenly, a new pattern of inflation**

In the meantime, one element has appeared, distinct from the Sub prime crisis, which is inflation. Not the inflation spurred by unit labour costs or rapid credit growth. But well the inflation induced by soaring commodity prices, out of the reach of central banks. Unsurprisingly, at the time of writing, global commodity prices were following lower a lower of crude oil prices, in the wake of the generalised economic downturn<sup>1</sup>. However, between January 2007 and mid-September 2008, Corn prices have gained 40%; they had gained up to 94% in June 2008. Idem for Wheat prices, which gained 151% between the start of 2007 and February 2008. The latter have receded since then (to 13%), but the dollar is also more expensive. From early 2007 to June 2008, the jump in Rice prices has been spectacular (they tripled, before receding to a double). Soybeans, Cocoa, Coffee prices were not outdone.

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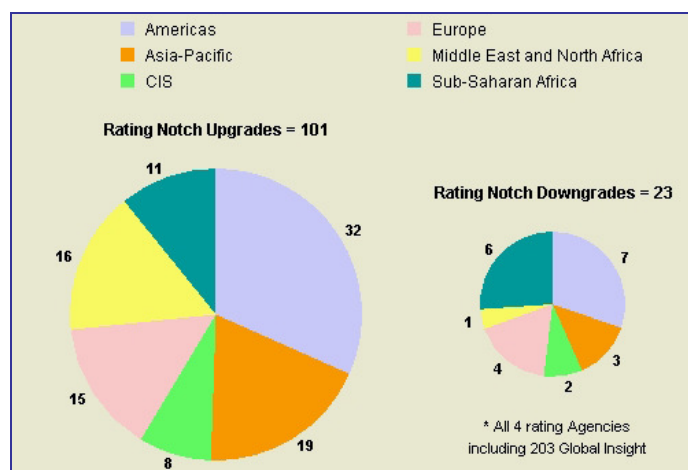
<sup>1</sup> At the time of writing, in the eye of the systemic cyclone, oil prices were hovering around USD100 a barrel, playing with a hesitant dollar; the greenback indeed does not know which way to choose: the upward trend because the systemic risk has been avoided by the unprecedented actions of the Fed and US Treasury, diminishing the prospects of a deep recession? Or the downward way usually followed when fiscal outlook is deteriorating?

Causes of this phenomenon are multiple: adverse weather conditions in Bangladesh and Myanmar, a farmers strike in Argentina, a rising demand from emerging countries whose middle-class appreciates a more elaborated food, higher transportation costs in the wake of oil prices, an increased competition between lands dedicated to food production and those booked for bio-fuels production, etc. etc., and of course, speculators attracted by the previous factors. Analysts of the late Lehman Brothers had assessed that total assets under management in Commodity indices had grown 235% (from USD70bn to USD235bn) between the start of 2006 and mid-April 2008; and of this USD165bn increase, more than half was accounted for by financial inflows to these indices, the rest stemming from price appreciation of the underlying investment, which has acted as a magnet for speculators.

Consequences of this phenomenon also take on diverse forms. Logically, these inflationary pressures guide the decisions taken by monetary policy committees of the Fed, ECB, and BoJ or other Bank of England. Each in his own way, Central Bank governors indeed refrain or limit the reduction of their interest rates, and search for other means to restore confidence of financial markets, through, e.g. facilitating interbank liquidity.

But even important - and this is the core issue of our reflexion - is the consequence of this food inflation issue on emerging countries' financial health: for the coming months, we think that Rating Agencies and other Risk Monitors will indeed inevitably revise down their opinion on a series of Sovereign borrowers' capacity to pay back their debt. And from them, investors will require higher yield on these debts.

Flash-back: coupled with a broad bank credit expansion, the Commodity boom, between 2002 and 2007 enhanced economic fundamentals of many emerging countries, exporters of these goods. In Latin America, Brazil is the latest example. Soaring prices and volumes of Brazilian exports have helped inflate its International reserves and lower its external debt, which convinced Standard & Poor's to bring it to its Investment Grade category (BBB- or better). Before Brazil, in the past three years, India, Morocco, and Peru have also entered the Investment Grade category of at least one Agency out of the three major S&P, Moody's or Fitch. Other upgrades have occurred, like those of Ukraine and of Indonesia, both rated B+ three years ago by S&P, now BB-; excellent for their debt service. During 18 months trough December 2007, Global Insight had monitored rating actions by S&P, Moody's, Fitch, and its own Rating Team: its conclusions showed that out of 124 rating moves, 101 were upgrades, and 32% of them occurred in Latin America, 19% in Asia and 16% in Middle-East and North Africa.



In the meantime, the commodity boom has also permitted some exporting countries – through finding peace deals, tidying up public finances, or developing infrastructure projects – to be granted *for the first time* a sovereign rating by mentioned agencies. Thanks to this new international visibility, Gabon, Kenya, and Nigeria are three African countries that today have accessed international capital markets; investors can now compare this trio with similar sovereign bond issuers. For a country, another advantage of a sovereign rating is that it provides a kind of benchmark to its corporate, and helps develop domestic capital markets, useful for the financing of the economic activity and of its diversification. These upgrades have lured foreign investors, and allowed deeper banking penetration.

But if the commodity boom has allowed upgrades, the commodity bubble<sup>2</sup> will inevitably lead to downgrades. Countries that export one commodity often have to import other ones, of another kind. Let's take the case of Egypt. Thanks to recent significant gas deposits discoveries, M. Mubarak's government is trying to revive its energy sector and to revert the declining trend of its crude oil exports. Since 2005, Gas sales, together with Suez Canal receipts, foreign aid and tourism revenues, have helped Egypt confirm its BB+ rating. In the meantime, thanks to better domestic economic conditions, controlled prices on basic items – often imported foodstuffs - have been liberalised without excessive inflationary consequences. Bread, fuel, tobacco prices have been freed, easing pressure on the government's budget, one favoured indicator in Rating Agencies' tool box. South-Eastwards, Indonesia's government has pursued the same objective, when it reduced subsidies on fuel consumption, in October 2005. Consumer prices suddenly jumped in end-2005, for this "technical" reason, but rapidly went back into lines, and risk assessors welcomed the move. Diverting money from a costly subsidising policy to more productive goals has indeed helped Indonesia's sovereign rating improve, from B+ to BB-.

More recently, when food prices soared to unprecedented levels, the first "Food protests" were reported, in Morocco in September 2007. The financial press at that moment didn't talk much of it, and devoted most of its pages to the interbank no-confidence. Though, numerous poor's in Burkina Faso, Haiti, and Egypt also went down in the streets, protesting against soaring food prices, sometimes clashing with security forces. Ethiopia, Somalia, Mauritania, Pakistan, are no exceptions.

The first duty of the mankind is to prevent such food crisis from happening. For the authorities of these concerned countries, the way they're answering this crisis is very delicate. In Egypt, 40% of total population lives with less than 2 US dollars per day. In Bangladesh, the poor's represent 84% of the population. One easily understands that President Mubarak's temptation is great, in order to bring calm downtown, to cap prices and defend the immediate interest of consumers. Several solutions have been tested: foodstuff exports limited or banned (in Argentina, India, Cambodia, Pakistan...), removal of import duties (in Nigeria, Tanzania, Philippines, Peru), 30% hike of civil servants' salaries (in Egypt), none answer being risk-free. Argentina's barriers to wheat exports pushed up international prices, hurting poor population earlier importers of these products. Exaggerated hikes of salaries add to inflationary pressures – and circle is vicious -, and widen the gap between the have and the have-nots, raising further the risk of destabilisation of the regime. Here we are. Destabilisation. The governments are worried by this risk of destabilisation. The US Fed and the ECB are trapped between inflation and recession; the regimes in poor countries are trapped between inflation and ...inflation. Or they do nothing spectacular, waiting for international assistance that is seldom immediate neither

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<sup>2</sup> The bubble is inflated by speculators who do not look at the intrinsic value of the asset, but on its potential resale value

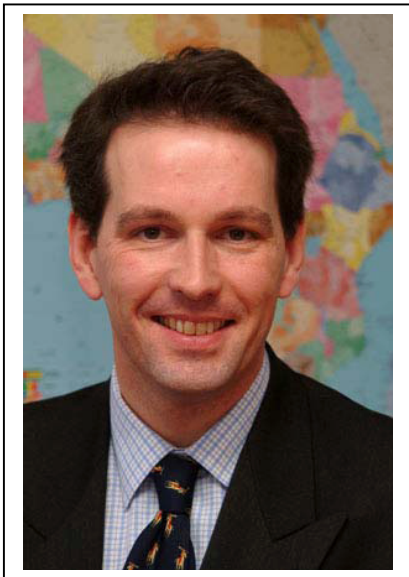
sustainable, and they take the risk of political destabilisation. Or they use public funds to alleviate the pain, with the risk of opening wider the inflation tap, dipping into the State's budget.

In both cases, rating agencies are expected to be merciless, Vietnam has done the experience. Political risk and price stability are two major components of Sovereign ratings. Inversely to an upgrade by S&P, or Moody's, or Fitch, a downgrade will mean for the country a more expensive external debt, which, in turn, will add to its annual expenses and weigh further of its fiscal balance; if no additional fiscal revenues can compensate them, the budget balance will deteriorate, and with it, the mood of risk assessors. The commodity boom has made them smile. The bubble will change their mood.

### **Capital Flight to Quality**

Earlier this month (September), the collapse of the Lehman Brothers Inc., a week after the rescue of Freddie Mac and Fannie Mae, plunged financial markets into trouble waters to depths never seen. Unsurprisingly, financial indicators in industrialised countries tumbled on difficulties encountered or suspected by US and European banks. Investors suddenly showed a total risk aversion, buying gold and US Treasury bills by way of safe heavens one day, ceeding to euphory the next Friday.

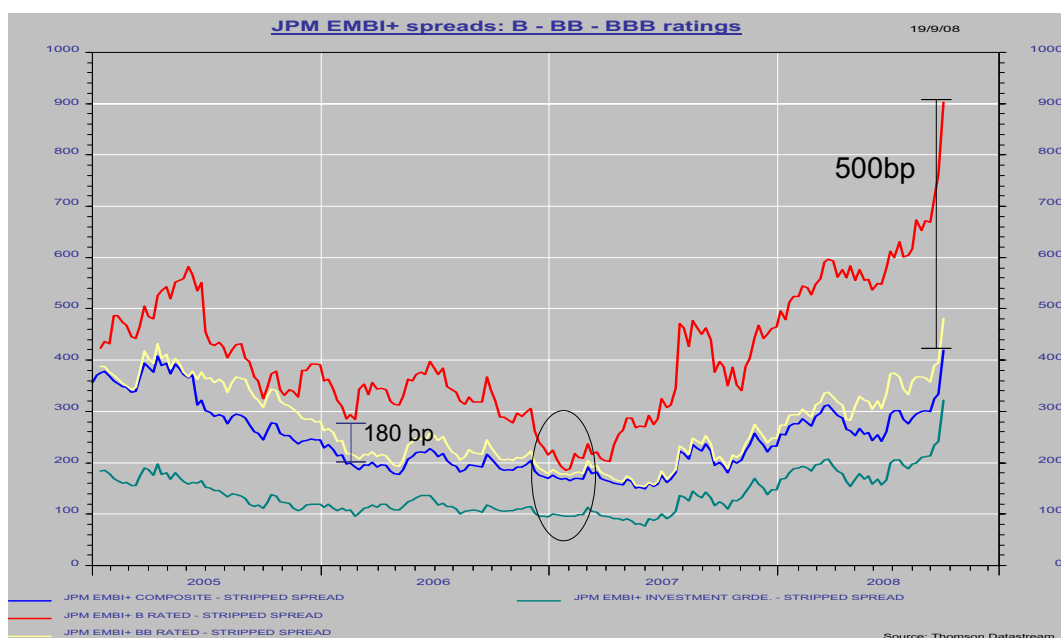
But in a panic move, they also massively withdrew their money out of emerging markets, pulling stock markets indices several floors lower. For emerging countries already struggling with high consumer prices, this panic adds to their woes. The direct impact of a stock market tumble is not that much important for their domestic economy: the stock market is indeed not (yet) the primary source of financing for companies, and individual investors do not make a majority of their population. But capital outflows – driven by foreign investors - weigh on the local currencies' exchange rates, which depreciate and add on existing inflation pressure. Unless emerging countries' central banks try to retain foreign capital, through higher interests rates, which makes credit more expensive and put a brake on investment, on economic growth, and on upgrade perspectives.



Louis de Fauconval  
Fortis – Economic Department & Country Limits  
[louis.defauconval@fortis.com](mailto:louis.defauconval@fortis.com)  
21 September 2008

## To Be or Not To Be Investment Grade

Published by JP Morgan, the EMBI (for “Emerging Market Bond Index”) spread shows the average risk premium paid by sovereign borrowers compared with their supposed risk-free US equivalent. On average, on May 21, 2008, emerging borrowers were paying some 261 basis points (bp) more than the US. Under normal economic conditions, some sovereign borrowers, depending on their reputation – i.e. their sovereign rating – have to reward investors a higher yield than other ones. This has not always been the case: during the third quarter of 2005 and in early 2007, strong economic conditions and massive flows of liquidity were blinding investors, who did not make a huge difference between a B rated borrower and another one, rated BB. However, now that global economic uncertainties are growing - and with them the probability of default, a B rated borrower is charged a risk premium of more than 900 bp, while the investment grade (BBB) borrowers are paying about 320 bp. Hence the advantage of being well perceived by rating agencies...



# The Role of Asset Securitization in Credit and Investment – Lessons to Be Learned from the Financial Crisis

**Author: Helmut Schnabel**

*Presentation by Helmut Schnabel, Chairman IAFEI, at the Asia Pacific IAFEI CFO Summit, in Taipei, Chinese Taiwan, on September 5, 2008*

*This is the full prepared text for the presentation. Due to the time constraints in the conference's timetable, only 70 percent of the full text has been presented.*

Asset securitisation, over the past 20 years, has grown into a major element and key characteristic of modern efficient capital markets, to the degree of even being one of many cornerstones of such modern efficient financial markets.

Along with asset securitization, comes the phenomenon of disintermediation. Mediation, by contrast, is the classical role of the banks: bring together those, who want to invest money, with those, who are borrowing money, in order to make real investments. In this classical model, the bank steps in between the depositor and the borrower. Disintermediation does reverse this model, by creating an investable security, which directly finances assets without an intermediary bank standing in between.

Asset securitisation is a complex phenomenon, for which a great number of variations exist with individual and distinguishable names like ABS's, Asset Backed Securities, like CDO's, Collateralized Debt Obligations, or CLO's, Collateralized Loan Obligations, or RMBO's, Residential Mortgage Bond Obligations, to just name the most common ones.

As collateral for such asset-backed securities, can serve a wide variety of assets, especially bank loans, corporate bonds, but also emerging markets sovereign debt and project finance debt. In addition to such plain vanilla assets, also so-called structured finance securities are serving as collateral, which themselves are special asset-backed securities like residential mortgage-backed securities, commercial mortgage-backed securities, and real estate investment trust debt. Collateral can also be other CDOs, whereby we then have CDOs on CDOs, which are also called CDO-squared. For the purpose of bundling the collateral, and of issuing and selling the CDO's to investors, always a corporation of its own is set up.

The investible securities issued by a CDO-corporation, are broken down to senior tranches, rated AAA, mezzanine tranches, rated AA to BB, and equity or capital tranches (unrated). The cash flows of the collateral pool are paid to the holders of these tranches in a specific order, starting with the senior tranches, the least risky ones, and down through the various levels to the equity tranche, the most risky one. If some of the expected cash flows to the pool are not forthcoming, for instance, because some loans default, then, after a cash flow buffer is depleted, the equity tranche holders are the first, to observe payment short falls. (The capital note holders are the "first loss investors".)

If incoming cash flow payments into pools are reduced further, the next set of tranche, the mezzanine tranche, does not receive full payment. Typically the tranches at the top of the capital structure are constructed, so that they qualify for AAA ratings, meaning there should be a very low probability of not receiving their promised payments.

The first CDO was issued in 1987, by bankers at the now defunct Drexel Burnham Corporation. There is not much transparency, today, about the size of this market, but here is an indication:

Global aggregate CDOs annual issuance totalled 150 Billion US \$ in 2000 and 1.2 Trillion US \$ in 2007. The cumulative outstanding amount is in the order of 5 to 6 Trillion US \$. ( Source: IMF)

Of all CDOs issued globally during 2007, round about 50 percent of them were backed by other securitized products, so called structured products.

Including all other forms of asset securitization into the greater universe of asset backed securities at large, ABS, the total annual issuance of ABS, in the USA and Europe, in 2007 was 2.6 Trillion US \$, resulting in a total outstanding amount in the order of 12 Trillion US \$ (source:IMF).

In addition to that, there exist also, CDOs, not on plain vanilla assets, but on credit default swaps, which are usually not counted as asset backed securities. The total outstanding volume of such CDOs, based on credit default swaps, in mid – 2007, was at 18 Trillion US \$ (source: Bank for International Settlement).

There is wide spread agreement, that the essential benefits of asset securitization are as follows:

- 1.) Securitization is increasing the volume of loans which can be made, beyond the loaning capacity of the banks, by giving access to new investors.
- 2.) Securitizations create alternative investment opportunities for investors.
- 3.) Securitization allows for a broader spreading of risk

The driving forces for asset securitisation are this:

The investors wish to invest in a broadly diversified portfolio of loans or other debt entitlements, and they wish to get a somewhat higher return, than they would otherwise get on conventional investment instruments. The investors typically are institutional investors, to a large portion other banks again, but then also investment funds, pension funds, pension schemes of corporations, insurance companies, foundations, and finally also other CDO's and structured vehicles.

The producers of asset securitization, the creators of CDO's and CLO's, are usually investment banks and their motive is to make a good fee income from constructing such CLO's and CDO's.

The suppliers for the collateral for such asset securitisation are usually the banks which want to unload packages of loans and other similar instruments from their balance sheet, thereby diversifying away risk they had previously taken, and thereby decreasing the need to hold the scarce equity against the loans made, an equity offset which is required by supervisory banking regulations, but also by common financial sense.

In the special case of US subprime mortgage loans, an additional market player comes in, the mortgage broker, who solicits mortgage loan customers, without making a loan himself, and does then pass them on to the mortgage loan bank, against a fee.

While this concept of CDO's is clear, and logical, and understandable, the devil is in the detail, as a famous saying goes, and the devil in this case means, that this complex structure of asset securitisation lends itself to a number of traps, into which the generators or the investors or both can fall, if they are not careful enough.

Ladies and Gentlemen, since the summer of 2007, we know, and we were forced to gradually take notice of, that asset securitisation has lent itself to being the epicentre of one of the worst financial crises, by which the modern financial worldwide system has ever been affected.

Starting point were CDO's, which were collateralized with loans from the so called subprime segment of the U.S. homeowner mortgage market. All of a sudden, there was turmoil and losses in this segment of the asset securitisation market, and this turmoil is ever since spreading in reverberating waves into other segments of the financial markets not only in the USA, but also in Europe in particular, and somewhat in Asia.

These turbulences, have joined forces with recession fears in the USA, and together they have led to a dramatic fall in stock prices, at large, worldwide, in almost all national stock markets. And in particular the stock prices of banks and other financial firms have to a large extent collapsed, in all the cases, where such banks and other financial corporations were grossly affected by the losses that overtime became visible in such CDO's and CLO's.

Again, the starting point of the crisis is the subprime mortgage segment in the USA, where excesses took place during 2005, 2006, and during 2007, when making loans to private home owners, which are in fact totally unbelievable. Not only did credit banks, large scale, make mortgage loans to private home owners by up to 100 % of the present market value of the house, but also agreements were made not to amortise part of the loan over the first few years. In addition extremely low interest rates were contractually arranged for the first one to three years which later on had to be compensated with interest rates which will then have to be above then existing market rates. And, even worse, in many cases the creditworthiness of the borrower was not examined at all by the bank. In summary this was lax lending at its worst.

This lax lending practice by U.S. mortgage loan banks is beyond standard professional imagination, and so is the lax supervisory regulation, that went with it. The world press has extensively reported about it.

And this lax lending practice has been done, in the end, against the background of the expectation, that house prices would increase annually and forever, and that afterwards, by way of market value appreciation of the houses, the loaning ratio against the asset value of the house would be lowered to a reasonable lower ratio.

To make the situation even more extreme: Such loans were not initially made by mortgage banks, but they were brokered by so called mortgage brokers who are self employed brokerage professionals. For them, what counted, was to catch the fish and to broker it away to the loan making bank, and thereby earning a fee.

The mortgage banks, which made such loans, then sold huge portfolios of such loans to investments banks, which bundled them into packages and which then used such packaged portfolios for the newly created securities, the already mentioned collateralized debt obligations.

The closing stone for such structures, meaning such collateralized loan and debt obligations, where top investment grade, credit ratings, which were issued by the US rating agencies for a great part of such CDO- and CLO-tranches.

The strategy and the drama, then took its course, when all of a sudden the ratings of such CDO-tranches were downgraded by often 17 notches, and were falling from an AAA rating in one step down into a sub investment grade rating, meaning into a speculative grade rating. Together with that, all of a sudden, the market value of such CDO- tranches fell first to 90 or 80 Cent on the Dollar, and further on to 60, 50, 20 and even zero. In the first quarter of 2008, alone, rating agencies made 4500 downgradings of tranches of CDO's.

Another phenomenon must be mentioned, that comes along with the phenomenon of asset securitization, and which has made headlines, and which has added to the financial crisis. What I mean with this, is the so-called structured investment vehicles, and, similar to that, so called conduits.

A structured investment vehicle (SIV) is a fund, which borrows money, by issuing medium to short-term securities at lower interest, and then invests this money by buying long term investments at higher interest, making a profit for investors from the difference. SIVs are a type of structured credit product. They are usually from 1 Billion to 30 Billion US \$ in size, and they invest in a large range of asset-backed securities, as well as directly in some corporate bonds.

There are 2 risks for such structured investment vehicles: 1, that invested assets are defaulting, 2, that the re-financing, much done by medium term notes and by commercial paper, cannot be rolled over at a given point of time and dries up.

Structured investment vehicles have a small portion of equity financing, so-called capital notes. Leverage on average, is 14 times, but also higher in individual cases.

Conduits, by contrast, are less leveraged than special investments vehicles. However debt financing is exclusively based on commercial paper, which is short-term financing.

Such structured investment vehicles and conduits are typically being held by banks and by other institutional investors. It is common practice, in the USA, but also in European countries, that the banks hold huge pools of assets off balance sheet by way of such structured investment vehicles, and that they do not consolidate them in their group balance sheets. On the asset side, such structured investment vehicles were often totally invested in CDO's and CLO's, with much U.S. subprime mortgage loan content.

The total estimated balance sheet volume of all structured investment vehicles plus conduits, outstanding, is estimated to be 1.8 Trillion US \$ ( Source: IMF).

As long as we had fair weather markets, and as long as the return on the asset side was higher, than the cost of the short term debt financing, the organizers of such special investment vehicles made good additional profit. But when the value of such CLO's and CDO's collapsed, then huge losses in such structured investments vehicles have arisen which then had to be compensated by the bank which had sponsored and erected the structured investment vehicle.

In addition, commercial paper refinancing was partly drying up, and back up bank credit lines had to be drawn down which had also been committed by the sponsoring banks of the structured investment vehicle.

In Germany, as an example, the smaller sized banks, IKB, and Sachsen LB, had engaged themselves in such structured investment vehicles, which, after they started collapsing, caused that the two banks were collapsing and they had to be saved in one

case by a government owned bank and in the other case by one of the largest savings banks.

In the case of the German small sized bank IKB, the total losses up to now amount to 16 Billion €, and the loss compensation provided mostly by a government owned bank and some private banks, amounts to 12.8 Billion €.

Many banks which have invested in the asset securitizations, which later on defaulted, did obviously not fully understand, in what they had invested, and also, they therefore did not apply an adequate risk management to these investment positions. Quite obviously, they were driven by an exaggerated search for yield, and there was also a certain herd behaviour effect. True is also that no bank, no other investor, were forced to invest in such things.

By the way, many observers say, that the extraordinarily high liquidity, which was around financial markets worldwide in recent years, is another major cause for the financial crisis. The argument is, that extraordinarily high worldwide liquidity has made investment opportunities relatively scarce, thereby pushing down yields, and thereby creating incentives for a new search of yield-pick up, which then drove investors into new investments, which they did not fully understand.

Also, we now know, that the liquidity risk of owning asset backed securities has not been recognized properly, and that in the case of many CDOs adequate illiquidity premiums have not been priced in.

What made the collective situation of defaulting CDO's on the one hand, and defaulting structured investment vehicles and conduits on the other hand, even worse, and in the end unbearable for the financial markets, was the lack of transparency about who was invested with how much in CDO's on the one hand, and in structured investment vehicles and conduits on the other hand. This lack of transparency has caused ongoing rumours, day in, day out, and the question, by how much individual major banks such as the big US banks but also the big European and Asian banks are being invested in such securitized assets. What we have seen is, that it has taken months after months, until gradually the truth came out. And the truth is now this:

Up to now, the worldwide losses, and depreciations which had to be made, by banks on CDO investments and on structured investment vehicles, by now, have accumulated to an amount of 512 Billion US Dollars. Most of such depreciation has been made by several major U.S. banks and by some major European banks. In Europe the largest single victim bank for such depreciation was UBS from Switzerland. In the USA, the largest single victim banks were Citigroup and Merrill Lynch. Such heavy losses of the banks have destroyed so much of their equity, that many of them had to take emergency equity refunding measures: Collectively, so far, the banks had to raise 353 Billion US Dollars.

In the USA, nevertheless, so far, 9 smaller sized banks have gone bankrupt because they have been too heavily invested, directly and / or indirectly, in U.S. subprime mortgage loans.

Among such 9 banks is the California-based IndyMac Corp, a mortgage lender. This bank has specialized in a type of mortgage, which did not require borrowers to document income.

The international monetary fund has recently published an estimate, according to which the total losses from this financial crisis to the amount of 1 Trillion US Dollars have to be

expected. Should that become true, then half of it, almost 500 Billion US Dollar depreciation losses, still have to come.

The gradual emergence of news, over several months, of unprecedented losses at some of the most famous banks in the USA and in Europe, and other not so famous banks, finally, and already in September 2007, further exacerbated the crisis, when banks all of the sudden started, to not trust each other anymore, and to not make short term loans to each other anymore, which then forced the central banks on both sides of the Atlantic to provide emergency liquidity to the markets in huge scale amounts. And this not only in September 2007, but ever since, repeatedly, also in December 2007, January 2008, March 2008, and again in summer 2008.

This cocktail of ongoing losses at banks and institutional investors from investments in CDOs, of distrust among banks and of drying up of the inter bank short term money market has led, over the past 12 months, to numerous serious consequences in other parts of the financial markets at large. The most noteworthy developments are the following:

- Credit spreads across money markets and long-term securities markets have gone up considerably across the board, without exception. This spread widening has to be welcomed, given that spreads, before, had been too low.
- Parallel to that, a flight to quality took place, meaning that long-term and short-term treasury rates started falling during the first 9 months of the financial crisis. In the USA, the 10 year treasury rate fell from 5.5 percent in mid-summer 2007 down to 3.3 percent in March 2008. In Europe the respective rate fell from 4.6 percent to 3.6 percent.
- Starting in January 2008, stock markets worldwide were grossly affected and took a dive by round about 20 percent from 2007 peak levels until March and July 2008. Part of this stock price fall was also explained with fears about an upcoming recession in the USA.
- Another example: In the USA, the asset-backed commercial paper market had a total size of round about 1.2 Trillion US \$ in July 2007. Much of this asset-backed commercial paper was financing off-balance sheet funds of banks, such as structured investment vehicles, on a short term basis. Such vehicles, themselves, typically held also assets such as CDOs and CLOs. When the financial crisis broke out in mid-summer 2007, many of these asset-backed commercial paper funding sources shied away from such structured investment vehicles and forced them, to unwind holdings, which both exacerbated the collapse of the US CDO market, and considerably shrank this financing source to now roundabout 700 Billion US \$.
- Another example: In early 2008, the 330 Billion US \$ market of auction-rate securities, in the USA, became totally illiquid. Auction-rate securities are issued by municipalities, closed-end funds, and student loan organizations. They are long-term bonds, with interest rates being re-set every week or month through bidding, run by dealers. When the Wall Street banks faced declining demand for these securities, they stopped in February 2008, the once-routine support of auctions, and they permitted also such auctions to fail and leaving investors unable to sell the debt.

These auction-rate securities are attractive to the issuers, because they provide the cheaper money market rates on their debt than the usually higher long-term rates for long-term bonds. But when the market became

illiquid, the interest rates were re-set according to the securities covenants, to much higher, but capped rates. In the case of municipal notes as high as 12 percent, whereas the closed-end fund notes were re-set and kept, below money market rates, at around 3 ¼ percent.

Investigations by the New York State attorney General Andrew Cuomo a few months later disclosed that the largest investment banks which make a market in these securities – Citigroup, UBS AG, Merrill Lynch, Morgan Stanley, JP Morgan Chase, Wachovia – had still sold such securities as quasi money market securities to the market at large, when they already knew that they would soon stop the auction and that this market would become illiquid. The settlement now reached with the New York State attorney general is for round about buying back almost 60 Billion US \$ of such securities by the 6 banks from the present investors, thereby adding to the banks assets that may cause further depreciation. Also, fines have been imposed on the banks. (Meanwhile, settlements have also been reached with small players in this market, like Goldman Sachs, Deutsche Bank. Other smaller players will follow.)

Through such buy backs, and also through re-financings, the market for auction rates securities has in the meantime shrunk from 330 Billion U.S. Dollars to about 200 Billion U.S. Dollars.

- A last example: In Europe, sales of asset-backed bonds which finance all kinds of assets, did fall, from an almost 400 Billion Euro volume in 2007, by almost 80 percent during 2008, because investors demand record high yields, to make up, for some of the subprime losses, record high yields, which the generators of asset-backed bonds cannot offer. Up to now, during 2008, less than 30 Billion Euros of asset-backed bonds were sold to investors. Although banks created about 250 Billion Euros of asset-backed bonds this year in Europe. 80-90 percent of this years European securitizations have been designed solely for the purpose of accessing central bank liquidity, which has become a de facto substitute for capital market funding for many banks.

These have just been a few examples of the ramifications and of the contagions which were produced in other segments of the financial markets. There are more examples of ramifications and of contagions which, for the lack of time, I cannot mention here.

Since the end of 2007, there is the fear, that this financial crisis will finally impact the real economies in the industrial countries as well, and pull them into a recession or even a depression. Fortunately, the real economies have withstood such impacts. But very recently, during June and July 2008, the mood of all economic players in the industrialized countries has strongly deteriorated, and the financial crisis has worsened again for a third time in July 2008, after March 2008 (when Bear Stearns, the 5th largest U.S. investment bank, had to be saved), and after September 2007. At this point, let me put all the numbers, which I have spoken out so far, into a greater perspective.

The total of subprime mortgage loans in the USA reached the volume, in 2007, of round about 1.200 Billion US \$ or 1.2 Trillion US \$.

The total of private mortgage loans in the USA, now, has a volume of 12 Trillion US \$.

The total of the financial debt of the private households in the USA, in 2007, meaning mortgage loans, plus credit card debt, plus automobile financing loans, plus other consumer credits, amounts to approximately 14.5 Trillion US \$.

The US GDP amounts to 14 Trillion US \$.

The net worth of the private households in the USA, in 2007, that is their total assets minus mortgage loans and other loans, amounts to 58 Trillion US \$. This is the highest amount, which has ever been achieved in the USA.

To make a different kind of comparison: The market capitalization of the worldwide equity and bond markets, plus the worldwide assets of banks, at the end of 2007, amounted to a total volume of over 200 Trillion US \$. (Source: IMF, German Central Bank)

When making a comparison with these numbers, one realizes, that with a closer look at the total losses of presently 512 Billion US \$ from the US subprime mortgage loans, that this number, by comparison, looks smaller and smaller, depending on which comparison you make.

With this comparison, I do not want to make the painful losses, which are painful for an individual bank, and for an individual institutional investor, look small or even negligible. However, what the afore mentioned comparisons show, is, that the great fear and panic, which we have repeatedly seen in the financial markets over the last twelve months, have always been overblown at each given point of time. <sup>1</sup>

The lessons to be learned from the defaults in asset securitization and from the ongoing world financial crisis are predominantly painful, and plentiful.

First of all, it is not enough, to completely rely on a triple A rating, given by a rating agency to a CDO or CLO. The experience of the last more than one year is just ample proof to the contrary. What is necessary is to rely on one's own due diligence and judgement.

The governments and regulatory agencies in both, the USA, and in Europe, are presently working on projects of how to improve the quality of ratings as well as the regulatory oversight of the ratings agency industry. Several proposals are already on the desk, but no final measures have been taken so far.

The improvement of the quality of the ratings, is a subject of its own. <sup>2</sup>

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<sup>1</sup> To further underline this, let me make another comparison:

The already mentioned net worth of the private households in the USA of 58 Trillion US \$ translates into a gross worth of 72 Trillion US \$, when adding the round about 14 Trillion US \$ total debt of US private households.

The presently accumulated subprime mortgage loan losses of 512 Billion US \$ represent only 3,5 percent of total private household debt, and less than 1 percent of the gross worth of total US private households.

The asset to liability ratio of US private households still is 5.1 times, which is solid. Therefore, neither the US consumer will collapse, nor the US economy will collapse, from the subprime mortgage loan crisis.

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<sup>2</sup> The main aspects, which are being presently discussed and researched worldwide, are the following:

- Independence of ratings

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- Conflicts of interests in the field of structured financings and structured products like CDOs and CLOs.

In this context it must be mentioned that over 40 % of the income of the rating agencies comes from the rating of structured products, and from the counselling by the rating agencies given to the issuers of securitizations, about how to structure, in order to get a certain rating.

*(Footnote 2 is continued on page 9.)*

Other researched main aspects are:

- Potential conflicts of interest as a consequence of the remuneration of the agencies by the securities issuers
- Governance structures within the agencies
- Quality of the staff of the rating agencies
- Quality of the methods of the rating agencies
- Degree of information available at the rating agency
- Reaction of the rating agencies when the effective default rates materially deviate from the projected default rates.

In addition and most importantly, the following two subjects:

- Transparency of the rating process
- A clearer understanding of the message, which a rating is giving, and of the limitations, which ratings will always have.

This last point is particularly important. A rating is the expression of the probability of a default of the security, as evaluated by the rating agency. Not more and not less. Other relevant risks, especially market risks and liquidity risks, are not considered by the rating. And also the use of the same rating symbols, which are applied to traditional plain vanilla financial products, also for the ratings of the much more complicated structured products, in a way does disguise the risks of the complexity of such structured products, and it should be replaced by a different type of symbolics.

At the end, and most importantly, however, all market participants must always be aware of the fact, that external ratings are always only an external help and support. The ultimate responsibility for issuance of and the investment in securities, and in structured securities, always remains with the issuers and with the investors. This responsibility can never ever be sourced out.

In spite of the foregoing, many bankers are saying, that the market for structured securities can only function, in the end, if the risk evaluation through the rating agencies of the collateral portfolios and, resulting from this, of the rating categories for different tranches of securities issued by a CDO, is adequate, and if the market participants have a high degree of trust in the ongoing reliability of such ratings. Again, correct ratings, so the bankers, are a necessary prerequisite, that the market for structured products and structured securities can function and survive in the long run.

But in spite of this, until measures for the improvement of ratings will not have been credibly taken, and until they will not have been practiced in a satisfactory manner, investors are well advised now, not to rely on

Secondly, know, what you are investing in. And when you want to invest into a CDO and a CLO, make your homework, study the structure of the security. And if this due diligence is too onerous for you, if you don't have the manpower to have it get done, then just stay out of the instrument and invest in more conventional and clearly understandable instruments.

Thirdly, always be aware: "Where there is smoke, there is fire".

Fourthly, at the beginning of the financial crisis almost all banks said, that they are not impacted or barely impacted. It then came out, over a series of months, that some of them were hugely affected and that emergency refinancing for the entire bank had to be done. Worse than that the stock prices of some of the most famous banks of the world have fallen by 50 to 75 %. The investors, who sold the shares of the banks at the beginning of the crisis, and who did not believe in what the banks were telling them, are today better off, than those investors, who stayed with their investments in the stocks of the banks.

Fifth lesson: CLO's and CDO's, while having a triple A rating, were delivering up to 100 basis points higher returns than government bonds which also had a triple A rating. While this looks like a miracle at the beginning, it so turned out, that the higher return was going along with higher risks which then became a reality and even led to heavy losses. The lesson here is: The higher the return, the higher the risk, and vice versa.

The Sixth lesson to be learned is: Never have greed taking over control over your investment decisions. This, obviously, has been the most devilish driving force that got, otherwise prudent bankers and institutional investors, to invest in subprime mortgage loan based structured products.

Greed, like fear, are the two worst advisors to investors. What is necessary for investors, is to be level-headed, all the time, and to follow a middle of the road way, all the time.

Seventh lesson: An old rule has been proven, again, to be right: The access to new equity, from external sources, even in bad times, and even in times of emergency, is the most important cornerstone of a corporation's financing, and, thereby, independence. Some of the largest, and most famous, banks, like Citigroup, Merrill Lynch, UBS AG, have been forced by this financial crisis, and after their stock price had already depreciated considerably, to seek new equity from external sources in order to re-build their depleted equity, depleted by high depreciations on CDOs and CLOs and structured products. In each case, the order of size had a magnitude of 10 Billion US \$ or more.

While the search for such new external equity, in an emergency situation, was successful, the price, which had to be paid, was often high. A new shareholder, who provided 7.5 Billion \$ new equity, could arrange for preferred cash dividends, 11 % p. a., over 4 years, thereby diluting the value of the shares of the old shareholders. This was so in the case of Citigroup.

Other new shareholders who infused such huge amounts, could make an arrangement with the bank in the case of Merrill Lynch, that any further fall of the share price of the newly infused equity, would be compensated by the company, thereby putting the new shareholder at a smaller risk than the old existing shareholders. Again, a measure, which diluted the value of the shares of the old existing shareholders.

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ratings when it comes to CDO's and CLO's and similar instruments, but they are well advised to do their own due diligence and to rely, in essence, on their own judgement.

And in addition to that, the new sources of equity turned out to be, to a large degree, government owned entities, like state owned funds from the Middle East and Far East, thereby changing the shareholder structure of such banks considerably. In the long run it will make a difference, as to whether shareholders are governmental bodies or agencies or subdivisions, or whether they are private investors.

Eighth lesson: Disintermediation and securitization via CDO'S have grown, as said, over the past 20 years to a volume, as of recently, of annualized issuance of roundabout 1.2 Trillion US \$, and it has drastically but not totally collapsed in early 2008 to an annualized volume of 50 Billion US \$ only. For all the described and known reasons, securitization in the future will not be anymore, what it used to be. Some market participants predict a much smaller future for securitization, than it used to be.

The opponents of securitization, say, that the instrument has lent itself to be filled with toxic waste as collateral, like US subprime mortgage loans.

Some bankers have been courageous enough, to state in public, that certain collateralized debt obligations are quote *almost criminal instruments* unquote and that such instruments should be stopped.

In spite of this public debate, the fact is, that disintermediation and securitization do continue, throughout the year of 2008, but at a much reduced level. In the meantime, recently, securitization is already and gradually on the rise again.

The major trends that can be predicted for securitization in the future are two. Firstly, there will be dramatically better transparency in the future in securitization. What will be in CDOs and CLOs as collateral will be much better explained in the future, than ever before. And secondly, securitization, in the future, will reverse to much simpler instruments than the complex structures which we have seen.

Ninth lesson: The fair value valuation of securitized assets has given rise to a number of headaches. The first headache came up, when certain market segments completely dried up and collapsed, and no market was made, and no market prices were being set. The mark to market valuation of fair value had then to be substituted by mark to model valuation. This uses complex valuation models, which are based on assumptions, estimates, values based on past experiences, of the individual bank. Here we are in uncharted land. Rightfully, the IFRS regulations do not install a uniform valuation model for financial instruments without an active market.<sup>3</sup>

Another big headache which has arisen from the fair value accounting, is, that, as a consequence of lowering the book values, when markets are falling, the asset holding bank or other investor are often forced to make fire sales, thereby exacerbating the financial crisis and thereby creating a self feeding downward spiral. Many bankers, including the International Institute of Finance, have therefore made the request, that in such a crisis situation, the fair value method of accounting should be halted temporarily. Other bankers and observers are firmly opposing such a measure. The outcome of the debate is open. But it is to be expected, that the proposal will sooner or later be put into practice.

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<sup>3</sup> Rather, the emphasis must be on the improvement of the transparency of the valuation of financial instruments for third parties. To this, the standard IFRS 7 makes an important contribution, which has to be applied for the first time for financial statements of 2007. This IFRS standard is a good complement to the already existing reporting obligations for asset securitizations which are in place by supervisory agencies.

Tenth lesson: the financial market crisis has developed under the old supervisory framework of Basel 1. The great majority of banks in Europe does apply the Basel 2 regulations only since the beginning of 2008. This must be born in mind, when the regulatory framework is being re-discussed now. A number of regulations, which go along with the application of Basel 2, will provide for a better protection from developments, which we have seen during this financial crisis. For this reason, and before again changing the regulatory framework, Basel 2 must be applied in the real world first, for some time.

This applies especially as regards proposals for an overall one off increase of the solvability coefficient. To do this, it would be premature, because not sufficient facts are available as yet about which equity quotas the banks will have under Basel 2.

Most importantly, the new Basel 2 regulations have also established a number of equity capital adequacy and disclosure duties, which make it significantly less attractive, to amass structured products off-balance sheet, outside the banks.<sup>4</sup>

Having said this, it is clear and obvious, that it is of utmost importance, that Basel 2 will be put into practice worldwide quickly and in an uniform way. This relates especially to the USA. The timetable there says, that the banks can apply the new regulations, starting April 2009, at the earliest, and must apply them, in April 2011, at the latest. However, full application, already in the year 2009 must be achieved in the interest of the stability of the financial markets.

Eleventh lesson: The core problem of securitization by way of CDOs and CLOs is said to be, that credit risk is moved from the bank to the securities investor and that the credit risk therefore tends to not be properly managed.<sup>5</sup>

In response to this, requests are voiced from market participants, that the banks which originate securitizations, should keep part of the credit risk on their own books for the lifetime of the credit, and that only the major other part of the credit risk is passed on via securitization to the end investor. The argument says, the banks should withhold the first loss piece on their own books.

Of course, there is already a public debate of how big this first loss piece should be, and whether this will be the end of securitization or not. Keep an eye on this public discussion. Much of the future of securitization will be decided by the outcome of this discussion.

It has been said, in this context, by the Institute of International Finance, to which belong 375 banks and financial institutions from around the world, in July 2008, that it is

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<sup>4</sup> Especially the new disclosure requirements according to column 3, will have the effect, that the banks have to disclose the objectives and the role of the banks in the area of securitization, that they have to hold equity against securitizations, and that they have to disclose such securitizations by risk categories. All this will provide a much higher market transparency than was available so far.

In addition, many banks do already apply stress test to the securitizations. The new Basel 2 regulations make such stress tests for all banks mandatory.

<sup>5</sup> Whereas good fees are made in the US by the mortgage broker, then subsequently by the bank which constructs the CDO, and then subsequently by the rating agencies which provide the rating, no sufficient care is said to be taken, to manage the credit risk, once it is firmly attached to the securities investor. It has been said, in this context, that securitization of CDOs gives rise to questionable incentive structures. The rhetoric quote *originate to distribute* unquote shows, that the process of securitization has a built-in element of not taking enough notice of sometimes loose lending standards and practices, more so than if the loans would sit for ever on the balance sheet of the bank.

absolutely necessary, that banks do apply undiminished solid and prudent loan making standards, independently from whether the risks remain on the banks balance sheets or whether they are transferred to third parties via securitization. I thought, this goes without saying. But the fact is, that this reminder has become necessary.

Twelfth lesson: There is a public debate about securitization, and the concomitant special investment vehicles and conduits, from a higher perspective. Such a higher perspective not only takes a look at securitization as such, but also at its interdependencies with structured investment vehicles, with hedge funds, with the private equity sector, with money market funds and with parts of the brokerage and investment banking industry. It is being said, that all these institutions and phenomena have grown collectively into a so called “shadow-banking-system”, largely beyond the control and the reach of the central banks and other financial supervisory agencies. I am only mentioning this, because the public debate about how much more regulation and control over securitization is considered necessary is going on in this much greater mentioned context. The magnitude and interdependence of these subjects is obvious, and therefore not only single countries and banking associations are dealing with them but also the G8, the European Union, the Financial Stability Forum, created by a dozen countries, the IMF, and the OECD have started an ongoing discussion about these subjects.

Thirteenth lesson: There is admiration for the U.S. financial system and culture for many reasons. This admiration has greatly suffered, and continues to suffer. It is to be expected, and it can be expected, that the self healing forces of the U.S. system will work efficiently and will overcome damage.

There are also quite positive lessons from the present worldwide financial crisis, as follows:

- The crisis has not led to a collapse of listed bond markets and stock markets worldwide. On the contrary, throughout the crisis, bond markets and stock markets have functioned efficiently. Markets have remained liquid. Volatility did increase, but it remained in a digestible range. And the real economy did not collapse either.
- The crisis has not diminished the availability of bank loans to the real economy, neither in the USA, nor in Europe. It is true, that, as a consequence of the financial crisis, banks in general are requiring now higher margins for the loans they make to customers, and that they are tightening the loaning conditions. But, as said, volume of bank loans outstanding has not shrunk, only the volume of such bank loans outstanding is growing considerably slower with small single digit numbers, compared to recent years.  
Nevertheless, the world press, obsessed with pessimism, keeps writing, that there is a credit crunch. Thereby adding to spreading fear and pessimism.
- Central banks, in the USA, in Asia and in Europe – contrary to many negative comments – have acted efficiently, quickly and responsibly. Given the dangers of systemic crisis, which had always been around, central banks had no other choice than to act, the way they acted, providing huge emergency liquidity to the markets, thus avoiding a broad market credit crunch and helping to prevent the collapse of major banks. Yes, it is a nuisance, that banks have been bailed out, which had failed before not just because of bad luck, but because of evident mismanagement. But this had to be accepted, in order to avoid a much greater nuisance, had a collapse of several major banks led to a systemic financial crisis.  
Said Jean Claude Trichet, President European Central Bank: “What has been done until now, has been pretty well done, under very difficult circumstances.”

- The good news also is, that this worldwide financial crisis took place at a moment, when the real economies around the globe where in good to excellent shape and continue to be. Only because of the sound and continued strong growth of the emerging markets, and the good growth in the developed markets in Asia, Europe, and North America, that existed, could it so far be prevented, that the financial crisis affected the real economy.

Let me conclude, with a few philosophical lessons from the present financial crisis:

- The tragedy of the free market economy is, that total freedom includes the freedom of market participants to gradually undermine such freedom, on purpose or by incompetence. This is, why, for instance, we have anti-trust laws and why we have laws against unfair competition and against destruction of competition, and why we need checks and balances. A necessary effect of the present worldwide financial crisis is therefore, that we hear numerous voices for more supervision of the financial markets and their participants, especially the banks, but also insurance companies, hedge funds, and others. An additional supervision by governmental bodies and regulators, which will reduce, to a certain degree, market freedom, and – if overdone – will reduce innovation, creativity, and economic progress at large. The daily news is full of such debates about how much freedom versus how much regulation. An end to this is not in sight, but signs are ample that at the end, there will, and must be, more regulation, reporting, transparency and supervision. And more punishment for malpractice, not to forget that.
- Another sad philosophical aspect of this world financial crisis is the huge dimension of the losses that have occurred around the globe. The unexplainable is, that the causes for such huge losses could build up, over time, and for so long, in such a huge dimension, and that nobody seemed to realise it, and that nobody seemed to warn against it. The phenomenon, we are talking about, has traits of mania. Often quoted is the tulip mania, the flower mania, that happened in the 17<sup>th</sup> century in the Netherlands, which was first a long – lasting explosion of tulip prices and which ended with a sudden drastic financial collapse, and with big parts of the population falling all of a sudden into poverty.

The Corrigan-Report, presented in August 2008 by predominantly US investment banks, explains the phenomenon with

quote ***Collective human behaviour – unbridled optimism on the upside; and fear, bordering on panic – on the downside*** unquote,

A German playwright of the 20<sup>th</sup> century, Bertold Brecht, has characterized the philosophical phenomenon, which we also painfully know from the political arena, with the following, and quite simple saying:

Quote ***Stupidity makes itself invisible, by taking gigantic dimensions*** unquote.

The US subprime mortgage crisis took such a gigantic dimension, which went unnoticed for so long, and for too long.

But let me close with a positive note: Evidence and efforts are great, and visible worldwide, that this worldwide financial crisis will be resolved, and the world's financial stability will be greater from hereon, than what it used to be.

Thank you very much.

July 23, 2008

## Looking worse than expected

**Author: Billy Cortez**



Two years after the origination of subprime loans, losses on those loans continue to rise. No one knows what could be the total loss but the estimates are mind-boggling. Some estimates amount to as much as \$500bn; \$100bn from option-pay adjustable rate mortgages and an additional \$400bn from other loans. Up to now, the estimated loss figures continue to move higher.

Market players, clinging to hope that this downturn won't turn into a full-blown sell-off, aren't sure how long will this financial crisis be, and how it will eventually end. Legendary investor Warren Buffet and former Fed chief Alan Greenspan have recently expressed similar views that this crisis will be a long and deep one.

To begin with, this crisis began last summer when thousands of US subprime borrowers started defaulting on their loan mortgages; it has now escalated into a full-blown seismic credit upheaval, causing market panics in most economies of both developed and emerging markets; both economies are also now battered by an accelerating global inflation fueled by an almost weekly price increases in oil and food items.

Global inflation, after years of relatively benign price gains, has become a real threat faced by economies worldwide. Investors are coming to terms that this newly-resurgent inflation will cause another spasm of worry and fear in stock and bond markets, making things more complicated for businesses, households, and savers alike.

The days of easy credit are gone for now. Banks, saddled with bad loans, big write-downs, and soured investment assets in their balance sheets are seeking out more capital, in particular, from cash-rich countries from Asia and the Middle East.

Fannie Mae and Freddie Mac, America's two giant mortgage companies, that buy or guarantee four out of every five home mortgages made in the US, have been reported to be losing billions of dollars and would need at least \$20bn in new capital to survive. Moreover, analysts believe the US housing downturn will continue through 2009 and possibly even 2010, making it the worst housing correction since the Great Depression. Fed Chairman Ben Bernanke recently warned that over the rest of 2008, the US economy will grow below its usual growth trend because of continued weakness in housing markets, high energy prices and tight credit conditions.

It's true, we're told, to focus on the doughnut and not on the hole; to keep our own risk tolerance high; and to show guts and be a market contrarian, meaning buying into the market when almost everyone is bailing out. But if seasoned investors are expecting more violent swings both in the equity and bond markets, and when many else find it hard to see any relief in sight in the runaway oil prices because the oil market has

moved from a supply led market to a demand led one, the outlook becomes dicey. Clear signs ahead point to an international financial market more volatile and fraught with added downside risks leading to a choppy ride for most investors.

The biggest risk in investing, it's said, is playing it too safe; negative conditions of whatever nature, after all, don't persist indefinitely. There'll be painful adjustments in the days or months ahead but, at some point in the future, markets' fall will reverse course; there'll be tough choices to make, and great buying opportunities to execute. In fact, without much fanfare, Warren Buffet has been reported to be taking advantage of the market turmoil by going on a buying binge of some big corporations. But to those who will engage in contrarian investing, as this global economic storm intensifies, you just have to be prepared to stay the course, particularly during those moments when shares prices are tumbling down fast while sentiments of fear and nervousness remain strong in the financial world. Has the world's financial market become a cauldron of fears and anxieties? Where are the bottom fishers now that the investment world appears shaky and weakening?

Until hard and realistic monetary and fiscal policies get in place in most the affected nations, a global recession combined with high inflation (stagflation) may rear its ugly head, which could mean, it would be worse than expected in the global financial market.

Investors who are not in the league of Warren Buffet would then be well advised to fasten their seat belts tightly.

*Mr. Cortez is director for trust and investments at ATR Kim Eng Capital Partners. He's the 2008 FINEX Foundation board chairman. The FINEX e-mail address is [admin@finex.org.ph](mailto:admin@finex.org.ph) ; Its website is [www.finex.org.ph](http://www.finex.org.ph) .*

## Article: SEC Votes to Release Roadmap for Adoption of IFRS, August 27, 2008

### FEI Summary

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In an open commission meeting today, the U.S. Securities and Exchange Commission (SEC) voted unanimously to issue for comment a proposed roadmap for the potential use by U.S. issuers, for purposes of their filings with the SEC of financial statements prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB). The SEC also considered three issues related to foreign private issuers at today's meeting.

Additionally, this meeting was the first full meeting of all five commissioners, including the newest Commissioners Troy Paredes and Luis Aguilar.

Key messages of the meeting included the need for a high-quality global set of accounting standards that will, as noted by SEC Chairman Christopher Cox, converge the "language of business and finance" and improve investor confidence in global markets through improved comparability and efficiencies. IFRS as issued by the IASB is being judged as that high-quality set of standards. Chairman Cox noted that there are several key success factors in using a global set of accounting standards:

- The standards must be crafted in the interest of investors;
- The standards-setting process must be transparent;
- The standards-setter must be independent;
- The standards-setter must be accountable; and
- All stakeholders must participate in the standards-setting process.

The SEC noted that this proposed roadmap has been developed by considering the feedback received from its 2007 concept release on the subject, as well as from the many roundtables the SEC has held since March 2007, and its efforts in meeting with key stakeholders during this time. All commissioners emphasized that this proposal has been a very significant undertaking for the commission and applauded the efforts of the staff.

The SEC will issue the proposed roadmap for a 60-day comment period upon posting in the Federal Register.

The proposed Roadmap includes the following key dates to be considered:

- Mandatory adoption of IFRS in 2014. The proposal considers whether this should be staged from 2014 to 2016 depending on the company size (large accelerated filers – 2014; accelerated filers – 2015; non-accelerated filers – 2016).
- Considerations for early adoption on an optional basis for a limited group of U.S. filers. As proposed early adoption would be permitted for periods ending after 12/15/09. (Filings in 2010.)
  - Early adoption is being considered for a limited number of eligible companies with the end goal of allowing this only if early adoption enhances the comparability of information for investors.
  - Eligibility will be evaluated based on industry (determined by SIC codes) and company size (based on market capitalization).
- In 2011, the commission will evaluate progress on the milestones and make a decision as to whether to move ahead with the mandatory requirement to adopt IFRS in a future year (2014 or a subsequent time or not at all).

The release is broken into several sections for consideration:

- Key milestones and dates;
- Improvement in accounting standards and accountability and funding of the International Accounting Standards Committee Foundation (IASCF);
- Improvement in the ability to use interactive data with IFRS;
- Education and training efforts for IFRS;

- Limited early adoption of IFRS;
- Anticipated timing of future rulemaking; and
- Potential implementation of mandatory adoption of IFRS and whether this should be sequenced over several years.

As noted above, the ability to early-adopt IFRS by a limited number of U.S. filers will be based on industry (determined by SIC codes) and company size (based on market capitalization), and the overall use of IFRS within that industry. The proposal includes a procedure for companies that are within the largest 20 companies (based on market capitalization) on a global market basis in their industry to be able to obtain a letter of “no objection” from the Division of Corporation Finance to permit them to early adopt IFRS. Additionally, in order for an individual industry to qualify for early-adoption IFRS reporting must already be in use by a majority of those 20 companies on a global basis in their industry. The SEC has estimated that based on these criteria approximately 110 U.S. companies in 34 industries would be eligible for early adoption, representing approximately 14 percent of total U.S. market capitalization.

Additionally, the proposal will provide two alternatives for comment on “how” a company would early adopt. The commission will choose one of these methods for early adoption based on comments received.

- Alternative A would be consistent with IFRS 1, the standard for first time adoption of IFRS, and would require one year of audited reconciliation from U.S. GAAP to IFRS.
- Alternative B would require three years of unaudited reconciling for the same three years as the audited financial statements included in the SEC filing

Additional discussion points of note:

- Converged Accounting: Status of the updated IASB/FASB work plan for accounting convergence, which will be released shortly and will provide for converged and identical standards from the IASB and FASB in seven key subject areas (including revenue recognition) by 2011. All agreed that the execution of this plan is critical in moving convergence forward.
- LIFO Accounting: Staff indicated that the IRS is developing options for how to manage the fact that IFRS does not permit LIFO accounting.
- Need for a mindset change and the use of professional judgment in moving from U.S. GAAP to IFRS.
- The need to work with various state and federal regulators to identify and rectify contractual references to “prepared in accordance with U.S. GAAP.”
- Identified the need for proper education and training in IFRS as critical to a successful process. This is education for all stakeholders in the process.
- Some commissioners also noted that companies need to consider and plan appropriately because the commission could decide in 2011 not to move forward with mandatory adoption.

*Other Meeting Items of Note:*

Additionally at the meeting today, the commissioners unanimously approved moving ahead with the following three items related to Foreign Private Issuers.

- The commission approved adopting amendments to its rules regarding the circumstances under which a foreign private issuer is required to register a class of equity securities under Section 12(g) of the Exchange Act.
- The commission approved adopting amendments to the forms and rules applicable to foreign private issuers that are intended to enhance the information that is available to investors.
- The commission approved adopting revisions to the current exemptions for cross-border business combination transactions and rights offerings to expand and enhance the usefulness of the exemptions, and to adopt changes to the beneficial ownership reporting rules to permit certain foreign institutions to file reports on a shorter form.

*Prepared Aug. 27, 2008 by Christine DiFabio, Vice President, Technical Activities, Financial Executives International (FEI). This summary does not represent FEI opinion unless specifically noted above.*

*Article provided by FEI-USA. See also FEI statement next page.*

## Statement from Financial Executives International: SEC Proposed Roadmap for IFRS, August 27, 2008

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In response to today's announcement from the U.S. Securities and Exchange Commission regarding International Financial Reporting Standards (IFRS), Financial Executives International (FEI) has issued the following statement:

*"FEI supports the SEC's decision today to propose a Roadmap for U.S. issuers for filings of financial statements prepared in accordance with IFRS. We reiterate our belief that a detailed, tactical plan and additional guidance is necessary to facilitate moving a larger number of registrants to IFRS (as outlined in our November 2007 comment letter)\*. FEI maintains that, as companies prepare to move forward with such a significant project, a clear understanding of the end requirements are necessary before companies can develop the necessary systems and procedures to address the critical business issues. Therefore, we further support the Commission's decision today to identify a target date of 2014 for mandatory adoption of IFRS. FEI believes the Roadmap represents a critical step forward for all parties involved in determining a course for convergence, and applauds the SEC for its commitment to doing so.*

*In the coming weeks, FEI's technical committees will review the detailed proposal and plan to submit comment letters to the SEC further outlining our recommendations toward the proposed Roadmap. As an organization of financial executives we recognize the importance of working together with all stakeholders on this critical issue to ensure a process that provides for ongoing high quality and transparent information for the investing public. We recognize that the move to IFRS will be a gradual process for companies of all sizes, as well as auditors, investors, educators and the overall financial community, and we will continue our efforts with respect to infrastructure in order to assist them in preparing for IFRS through committee initiatives, education sessions, conferences and our involvement in the recently formed Corporate Roundtable on International Financial Reporting (CRIFR) "*

*\* Comment letter available upon request.*

### **About FEI**

Financial Executives International is the leading advocate for the views of corporate financial management. Its 15,000 members hold policy-making positions as chief financial officers, treasurers and controllers. FEI enhances member professional development through peer networking, career management services, conferences, teleconferences and publications. Members participate in the activities of 84 chapters, 73 in the U.S. and 11 in Canada. Visit [www.financialexecutives.org](http://www.financialexecutives.org) for more information.

### **Media Contacts:**

Nicole Madison  
FD  
212-850-5647  
[nicole.madison@fd.com](mailto:nicole.madison@fd.com)

Lili DeVita  
FEI  
973-765-1021  
[ldevita@financialexecutives.org](mailto:ldevita@financialexecutives.org)

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Paper provided by FEI-USA.

## **News: U.S. Meltdown Reflects Regulators' Failures, Said Wu Xiaoling, Former China Central Bank Deputy Governor**

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Sept. 18 (Bloomberg) -- U.S. regulators failed to manage the risks of new financial products and China needs to learn the lessons to avoid its own meltdown, former central bank deputy governor Wu Xiaoling said.

"The U.S. crisis reflects regulatory problems in the U.S. and innovative financial products that ignored basic economic rules," Wu told a financial conference in Beijing today. "The U.S. crisis today would be China's tomorrow if financial products such as securitization are introduced without proper risk-control measures."

China has resisted years of pressure from U.S. Treasury Secretary Henry Paulson to open its financial system more quickly and add new products. Those barriers helped the nation limit its losses and writedowns from the credit-market crisis to less than 1 percent of the \$516 billion global total.

"Now is the time for the Chinese to say that 'you didn't do it quite right either,'" said David Cohen, an economist at Action Economics in Singapore. "The world is very dependent on China to help cushion the downturn."

This week, the crisis drove Lehman Brothers Holdings Inc. into bankruptcy and forced American International Group Inc. into the hands of the U.S. government. Merrill Lynch & Co. sold itself to Bank of America Corp. Morgan Stanley is weighing a merger with Wachovia Corp. and other banks, people familiar with the matter said.

### **Asian Stocks Tumble**

Asian stocks tumbled to the lowest in three years today while gold and U.S. Treasuries surged as concerns mounted that more financial firms will collapse. China's benchmark CSI 300 Index fell 5.1 percent as of 1:27 p.m. in Shanghai.

Paulson said last year that China risked wasting trillions of dollars in resources and lost economic potential unless it rapidly opened its capital markets.

"An open, competitive and liberalized financial market can effectively allocate scarcer resources in a manner that promotes stability and prosperity far better than government intervention," Paulson said in Shanghai in March last year. "Time is of the essence."

China's government may thwart new financial products including derivatives and enhance risk-management practices to avoid a U.S.-style crisis, the bank regulator's deputy research chief, Fan Wenzhong, said today at the Beijing conference. He's also a former Lehman economist.

### **Stability 'Not Speed'**

The aim of China's financial reforms is "not speed, it's about stability," he said.

In the past three years, China dropped a decade-old currency peg to the U.S. dollar, introduced foreign-exchange swaps and forwards and expanded the bond market as the government moves to a more market-driven financial system.

It's yet to allow margin trading -- where investors borrow money to buy shares -- or futures contracts based on equity indexes. The central bank said last year that it was tightening disclosure rules on sales of asset-backed bonds.

U.S. banks "dared" to lend to riskier borrowers in the hope that a housing boom would continue and interest rates would stay low, Wu said. Sellers of financial derivatives "abandoned the principle of letting clients fully understand their risks," she said.

#### Crisis 'Far From Over'

Wu, the deputy director of the Financial and Economic Affairs Committee of the National People's Congress, which is China's legislature, wouldn't say when the crisis may end.

"No one really knows how many times these subprime derivatives were repackaged and how many times the risks were amplified, so the crisis is far from over."

China's losses and writedowns are \$4.3 billion, according to Bloomberg data.

The nation's stocks fell today as international credit markets seized up, stoking concern that more financial companies will collapse. Industrial & Commercial Bank of China Ltd., which has \$151.8 million at risk because of the Lehman collapse, dropped 4.7 percent.

*Quoted from Bloomberg News, September 18, 2008*

## **News: State Owned Funds Are Becoming Choosy Asians Have Bitter Experiences in the Financial Crisis**

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Singapore, September 17. – Koreans have been lucky. Still, in early September, the Korean Development Bank, (KDB), wanted to make an equity investment in the U.S. American investment bank Lehman Brothers. This one has now filed for insolvency, and Korea's state owned investor has made one more experience. There is also relief in Singapore, because the local Temasek Holdings, one of the two state owned investment firms, is holding 14 percent in Merrill Lynch. But even on the occasion of the takeover by the Bank of America, BoA, the Singaporeans still made round about 1 billion U.S.\$ profit. The two state owned investors from Asia show, how close light and shadow can be for state owned funds during the banking crisis: Whereas until recently unwelcome locusts, they are now money providers at whom the banks are lining up. But they have become cautious, and they are only anymore looking for cherry picking.

So, the funds from Dubai until Singapore, together with Barclays Bank, in which they hold equity, are now cutting out only the best pieces from Lehman Brothers, instead of saving the entire bank. Also an offer to invest in the German stock exchange has been rejected by Singapore. When the take over of Dresdner Bank was planned by the China Development Bank, Peking was vetoing it. And in view of the crisis at the U.S. American insurance company AIG, nobody of the still rich state owned funds is willing to invest. The more so as their expectations for the future are getting more pessimistic.

According to the view of the Government of Singapore Investment Corp. (GIC), the world economy is threatened with a stagnation, such as it could be observed as the "loss decade" in Japan. "In the short term, the process of deleveraging and deflation in the U.S.A. and other solid nations will in many places increase pressure on the business cycle", warns GIC-Vice President Tony Tan. "I do not think, that now is the time for state owned funds, to spend money. We should keep our capital and rather see first.", said John El Khair, Advisor of Qatar Investment Authority. "The state owned funds wanted to give a helping hand to the western financial institutions, while under pressure. Unfortunately, in so doing, they only made losses, and they also heard a lot of critique regarding their lack of transparency", said David Rubenstein, Co-Founder of Carlyle-Group.

Effectively China is an example for wrong investments. The China Investment Corp. (CIC), which was worldwide respected upon its foundation, with an investment volume of round about 2 billion U.S.\$, has significantly decreased the book value of its portfolio by way of wrong investment decisions. So, CIC invested with 3 billion U.S.\$, and without luck, in the IPO of the Financial Investor Blackstone Group LP in America, which since then has lost half of its value. For additional 5.6 billion U.S.\$, the Chinese have invested equity at Morgan Stanley, the shares of which have in the meantime lost more than a quarter of their value. Similar to the Koreans, the state owned Chinese Citic Securities was lucky, when Bear Stearns broke down, before the Chinese invested in them. The bitter experiences of their leading state owned investment firms, too many people regard as one of the reasons, that the China Development Bank has been stopped with its projects by politicians, a project, to buy the Dresdner Bank. Already when they invested in the British bank Barclays in July of the last year, CDB paid for an ownership for 3.1 percent 1.5 billion pound (1.9 billion €). Since then, this stock lost almost 60 percent of its value. Attracted to its expensive wrong investment were the Chinese, probably, by Temasek and the investment cooperation of Dubai, which, each, also had taken over 2 percent of Barclays.

The best nose have proven, to have had, so far, the state owned investors of Singapore. Temasek, even from the failed investments by Merrill Lynch, will come out as winner. The

Singaporeans has paid in December 2007, 48 \$ per share. By way of a skilful hedging against stock price losses, the purchasing price at the end was only 24 \$. The Bank of America, BoA, is valuing the Merrill Lynch packet now with 29 U.S.\$, although it was valued at the end on the stock exchange with 17 \$. On the bottom line, the Singaporeans made a profit around 1 billion U.S. \$.

*Quoted from Frankfurter Allgemeine Zeitung, September 18, 2008*

*Article translated by Helmut Schnabel*

## News: Henry Paulson's Farsighted Investment

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September 15, Opinion, Gunnar Heinsohn - 700 billion US \$ for the U.S. American Finance Minister Henry Paulson for the purchase of under secured mortgages are a lot of money. Its about 2.300 U.S. \$ for each U.S. citizen. If one adds the 85 billion U.S. \$ for the insurer AIG as well as the 200 billion US \$ for the mortgage banks Fanny Mae and Freddie Mac, then a total of minus 3.300 U.S. \$ for each U.S. citizen is reached. However, this short of one trillion U.S. \$ could turn out to be an unusually skilled investment. According to estimates of the American "Census Bureau" of August 14, 2008, the USA, between 2010 and 2050 shall have additional 130 million inhabitants, thereby adding from presently 310 to then 440 million inhabitants.

130 million new inhabitants – more than a third of whom are well chosen imigrants – are the equivalent of the combined population of France and Great Britain or of short of Russia. With presently 3 human beings per American household, there will be demand for almost 45 million additional houses and apartments. At an average price of 300.000 U.S. \$ per housing unit end of 2007 – at the end of 2006 it was still 322.000 U.S.\$ - the upcoming 40 years will bring along an additional demand at today's prices, in the housing sector of 13 billion U.S. \$.

Behind the freshly incurred government debt of 1 billion U.S. \$ stand real houses. They are not paid, or the inhabitants are behind for many months with paying interest, but they exist, and they are in addition at the newest state of the art. To sell them, one after the other, on the background of the cumulative demand of 13 billion U.S. \$, should not be too difficult. And if then, the U.S. finance minister will pay back to each American his 3.300 U.S. \$, and in addition his share of the profit from the sale of the houses, which had been purchased before at extremely favourable prices, then such simple tax payers could regard themselves, all of a sudden, as shrewed investors.

In many areas of Russia, Eastern Europe and East Germany, house prices are falling from 100 to 20 or even 0 percent, because these regions are in the middle of a demographic melt down – without qualified emigrants and with 1,3 children per woman life, versus 2,1 in the U.S.A.. The area between the river Elbe and Wladiwostok will have the population shrink from 360 million habitants in 2005 to, at the highest, then 240 million in 2050 (CSIS, The Greying of the Great Powers, Washington DC, 2008). This, however, is an optimistic estimate. Because the young ones and the clever ones in these in total 23 countries will not wait until the end of the implosion; many million of them – apart from the 130 million new citizens in the United States – will look for a new home between New York and San Francisco. For this reason, the above mentioned estimate for the U.S. American population in the year 2050, will not be at 440 but even at 520 million. From a demographic one to one ratio, for 1870, between the USA and Germany, with at the time in each country 40 million inhabitants, in year 2050 there will be an eight to one ratio for the USA, with then only 65 million people in the Federal Republic of Germany .

American home prices may sink from 100 to 90 or 80 percent. But until they are trending towards 70 percent, half of the developed world will click into the internet page of google and look for a cheap buy, including among them the shrinking and greying east Asians (Japan, Korea, Taiwan and even China). Through this, the demand for new homes can quickly increase from 13 to more than 20 billion U.S. \$. And of then, if a panic purchasing of American real estate will ensue, then the even most angry U.S. tax payer shall realize, how well Paulson has invested his 3.300 U.S. \$. All of a sudden, he will feel sorry, for not having invested more on his own account.

Never the less, the outrage about monetary mistakes of the past will remain. But here again, so much can not be changed anymore. All calls for more regulation can only mean, to return to the old known banking rules: Firstly, commercial banks can only accept people and institutions as debtors, who can provide first class property as collateral. And secondly, central banks must have a high equity. They must let commercial banks with only a first class collateral to their counters and must never let the re-financing interest rate go down to zero.

As a comedian acts the U.S. American Finance Minister, however, when he calls on the Europeans to equally nationalize unpaid homes. Germany, for instance, has no future home buyers, but ever more inhabitants in despair, who want to sell, in order not to have to go, without means, in to emigration. The German government, for this reason, has already destroyed several hundred thousands of apartments. Otherwise, all real estate prices would have been in free fall and the domestic mortgage banks would have been in free fall and the domestic mortgage banks would have been bankrupt, because against their loans, there would hardly stand any more mortgage collateral. The U.S.A. can put houses and apartments on stock, and wait for better times, but in continental Europe, this is not possible.

*Quoted from Frankfurter Allgemeine Zeitung, September 15, 2008*

*Article translated by Helmut Schnabel*

## **News: Group Supervision For Banks European Union Finance Ministers Want to Make a Better Network of Controls**

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Nice, September 14. – The European Union can master the consequences of the new financial market turbulences in the United States, according to the evaluation of its central banks governance and finance ministers without great difficulties. However, it must, independently from this, improve the transborder for the market supervision further. This the result of the informal meeting of the Central Bank Heads and Ministers on the weekend in Nice. Their showed optimism, that the crisis of the U.S. American investment bank Lehman Brothers will have only limited results in the European banking system, should an orderly unwinding solution be found for the institute. At the same time, they agreed on principles for the further development of financial supervision for banks and insurances. These should serve as basis for concrete steps until the end of the year.

The President of the German Federal Central Bank, Mr. Axel Weber, said, as long as the liquidation of Lehman Brothers would be done in an orderly way, he is expecting only limited effects on the German banks. This impression he has won, after the Federal Central Bank, in the past week, has analysed the risk positions of domestic Germany banks. The Federal Central Bank will continue to be alert to stay in contact with the U.S. American banking supervision. The additional network, which has been established in recent months especially with regard to the international monetary fund, but also with regard to the European Union authorities, as regards cooperation in the supervision has proven to be effective in recent months.

As further part of this network, the presently acting European Union council Chairman France's Finance Minister Christine Lagarde, wants to establish, in this year, supervisory bodies for financial groups which are active across borders as well as for banks, as well as for insurances. This "Group Supervision" shall be applied in the entire European Union until 2012, at the latest, and in an uniform way. In these bodies, all national supervisory agencies of the respective countries should be represented. The ministers maintained the principles, in Nice, that in such supervisory agencies, in each case, this supervisory agency should take the lead, in the country of which the parent company of a group has its seat. Further details for an adequate cooperation between the home based supervisor and the guest supervisor still must be arranged.

Parallel to the ongoing works on the group supervision, European Union internal market Commissioner Charlie McCreevy will present, in October 2008, proposals, for a tighter supervision of rating agencies and of tighter equity regulations for banks. The Commissioner spoke about this, not publicly in Nice. According to participants of the meeting, however, he made it clear during the sessions, that, in spite of the sharp protests of this industry, he will continue to essentially maintain is plans. This related essentially to his intention, to obligate the banks to hold more equity against certain risks. According to the preliminary proposal of McCreevy from July 2008, the banks will only be allowed to continue to invest in loan based securities, when the issuer himself holds 10 percent of these papers – thereby remaining invested in this risk. This regulation is meant to induce the banks to more prudence in making loans and when supervising the outstanding loans. European banks are afraid, that they will be put at a disadvantage by way of such a regulation in the international competition.

He does know, that the industry does nor appreciate this proposal, said the Commissioner during the meeting in Nice. But the industry must take notice of the enormous costs for the world economy and for the tax payer, because the existing banking business model of generating, securing, and placing of loans ("originate to distribute") have overdone it: "I have made it clear, on various occasions, that behaviours must be stopped which go along with this model", said McCreevy in presence of high ranking representatives of the European financial industry. He said, that he has asked the industry for counter proposals. "Until now, there have hardly been any ones."

*Quoted from Frankfurter Allgemeine Zeitung, September 15, 2008*

*Article translated by Helmut Schnabel*

## **News: S&P Warns European Union against Unilateral Action “Global Regulation of Rating Agencies Would Be Better”**

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London, September 8, Dow Jones. The rating agency Standard & Poor's (S&P) has warned the commission of the European Union on Monday against a European unilateral action by way of regulation the rating agencies. In order to get better and more transparent ratings, it is said, that a “global coordinated solution” would be the best. Such solution to be based on the code of conduct which was presented by the International Association of Stock Exchange Supervisors (IOSCO). Such a solution would have to be preferred against regulatory rules, argues S&P. Along the same lines, S&P has argued in the consultations to the plans for regulations, which have been concluded on Friday.

The commission has not yet published, on Monday, the results of this consultation. However one will not spend much more time with the evaluation of the results of questioning industries on the subject. According to the internet page of the top management of the internal market division of the European Union, the draft of a legislation will still be elaborated during September, which has been announced by commissioner for the internal market Mr. Charlie McCreevy. The European Parliament has requested that the draft legislation is available in October at the latest, in order that the regulation can still be passed before the new elections for the European Parliament in June 2009.

The European Union finance ministers have, already, spoken up in favour of at least a European Union registration system for rating agencies. The commission of the European Union has proposed, in its consultation documents, two options for the control of the agencies: A re-enforced coordination role for the committee of the European Securities Industry Regulators (CESR), as well as a closer cooperation of national regulators regarding the creation of an agency for an European Union wide registration and control of the agencies by the national regulatory bodies.

Up to now, the rating agencies do not have to subdue to any supervision. For them, only the voluntary standards of IOSCO are mandatory. According to the commissioner of the European Union this is not enough anymore.

*Quoted from Frankfurter Allgemeine Zeitung, September 09, 2008*

*Article translated by Helmut Schnabel*

## **News: External Supervision for Rating Agencies European Union Commission Starts Consultations / Proposals to Be Issued in the Fall of 2008**

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Brussels, August 4. – The rating agencies must prepare themselves for a stricter control through external supervisors. This is the content of the draft of a mandatory regulation, which the European Commission in Brussels has issued for discussion. In this draft, the Commission proposes two ways for a better control of the rating agencies which are under criticism since the start of the financial crisis: A stronger coordination of the supervision by the Committee of the European Securities Regulating Authorities (CESR), and a closer cooperation between the national regulatory authorities, as well as the creation of an European Union Agency for the registration of rating agencies and concomitant control of the rating agencies by the national regulators. This task of the European Union Agency could eventually also be taken over by CESR, as said in the draft paper. Should the rating agencies not abide with the European Union regulations, they could be sued and could lose their licence.

The rating agencies, covered by the draft, have time until September 5, 2008, to send a reply. A definite draft of an European Union regulation will be presented by European Union commissioner Charlie McCreevy in the fall of 2008. The rating agencies are evaluating the quality of securities and the credit worthiness of corporations. They are being accused, for being partly guilty for the present international financial crisis, as they are said to have warned the investors too late, from the risks of the U.S. mortgage market. It is said, that by way of somehow protecting the client for which they were giving a rating, the agencies Moody's or Standard and Poor's had ignored the high risks of certain financial products and that they have reacted, too late, to the collapse of the U.S. American subprime mortgage market. Critiques say, that this so, because the agencies had been in a conflict of interest, as they have not been paid by the investors, but by the corporations for which they issued a rating.

Up to now, the rating agencies are not under any supervision, which would be comparable with the supervision of banks, insurance companies and exchanges. However, they have obligated themselves in a voluntary code of conduct, to apply, voluntarily, the standards of the International Organization of Securities Supervisors (IOSCO). McCreevy had already announced in June, 2008, that he wants to reinforce the external supervision of the agencies by the European Union. Also, the finance ministers of the European Union have recently spoken up for an obligatory regulation of the rating agencies.

The financial market crisis is said, to have shown, that the self-regulation of the rating agencies industry does not function, says McCreevy now. Therefore the European Union will put the rating agencies under a restricted supervision. Only in so doing, it is said, that the ratings are not being negatively influenced by conflicts of interest. In addition, at present, the European Union regulations are such, that an exaggerated trust is accorded to ratings. Through this, banks and other financial institutions have had incentives, not to once more scrutinize the books sufficiently. Also in this regard, the European Union regulations must be changed, so that financial institutions will become more active, again, themselves, in the future.

For this purpose, the various sections in European Union regulations regarding ratings will have to be revised, for instance in the equity directive Basel II or in the securities directive MiFID. For instance, the directive Basel II states, how much equity the bank must have, when they own certain securities or when they make certain loans, in order to cover the concomitant risks. When aligning the equity base, the risk evaluation by the rating agencies is therefore playing an important role. The European Union must now examine exactly, whether the rating agencies should be obligated, to disclose their methods and models, so that everybody can make an own judgement of the issued ratings, says the draft paper. Transparency can also contribute, to avoid conflicts of interests.

The proposal of the European Union Commission must be passed as well by the European Parliament, as well as by the Member States. The European Union Commission showed optimism, that both institutions can conclude their counselling until the elections of the European Parliament in June 2009. This, though, is only possible, when both of them agree on a common line regarding the rating agencies during the first section of the regulatory process.

The consultation documents can be viewed on the following website:  
[http://ec.europa.eu/internal\\_market/securities/agencies/index\\_de.htm](http://ec.europa.eu/internal_market/securities/agencies/index_de.htm)

*Quoted from Frankfurter Allgemeine Zeitung, August 05, 2008*

*Article translated by Helmut Schnabel*

## **IAFEI news, activities**

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**XXXIX IAFEI World Congress, Paris, France, December 14-17, 2008**

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