CHAPTER VII REMEDIES TO OVERCOME SUB PRIME, GLOBAL FINANCIAL CRISIS AND RECESSION

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CHAPTER - VII REMEDIES TO OVERCOME SUB PRIME, GLOBAL FINANCIAL CRISIS AND RECESSION

REMEDIES TO OVERCOME SUB PRIME, GLOBAL FINANCIAL CRISIS AND RECESSION

Effects of the subprime crisis and required corrections

Market fundamentalists ‘laissez-faire’ of the last 20 years has dramatically failed the test. Financial deregulation has created the build-up of huge risky positions whose unwinding has pushed the global economy into a debt deflation that can only be countered by government debt inflation. Significance needs to be attached to break the trend of falling asset prices and falling demand in a bid to revive the financial sector’s ability to provide credit for productive investment, to stimulate economic growth and to avoid deflation of prices.

Blind faith in the efficiency of deregulated financial markets and the absence of a cooperative financial and monetary system created an illusion of risk-free profits and licensed profligacy through speculative finance in many areas. Governments are well positioned to judge price movements in those markets that are driven by financial speculation and should not hesitate to intervene whenever major disequilibria loom.

The growing role and weight of large-scale financial investors on commodities futures markets have affected commodity prices and their volatility. Speculative bubbles have emerged for some commodities during the boom and have burst after the sub-prime shock.
The absence of a cooperative international system to manage exchange rate fluctuations has facilitated rampant currency speculation and increased the global imbalances. As in Asia 10 years ago, currency speculation and currency crisis has brought a number of countries to the verge of default and dramatically fuelled the crisis. Developing countries should not be subject to a "crisis rating" by the same financial markets which have created their trouble. Multilateral or even global exchange rate arrangements are urgently needed to maintain global stability, to avoid the collapse of the international trading system and to pre-empt pro-cyclical policies by crisis stricken countries.

The crisis has made it all too clear that globalization of trade and finance calls for global cooperation and global regulation. But resolving this crisis and avoiding its recurrence has implications beyond the realm of banking and financial regulation, going to the heart of the question of how to revive and extend multilateralism in a globalizing world.

There is no need for a new global financial system (Breton-Woods II) or for creating new international institutions from scratch. Rather, there is a need for strengthening the existing institutional framework by enhancing those general principles that ensure a smooth functioning of market economies; stability-oriented macroeconomic policies; high competition on all markets; the protection of property rights; freedom of contract; and unlimited liability.

Macroeconomic policies have to be medium term oriented and geared towards price stability and sound public finances. As regards the institutional framework
for the financial sector, we have to accept that even the tightest regulation cannot prevent a financial crisis. However, it is clear that the benefits of tighter regulation are larger than thought some quarters ago. Hence, there is a need for a realistic assessment of the costs and benefits of tighter regulation. New regulation should set general principles rather than drawing up long lists of discretionary measures, which are necessarily incomplete and invite renewed regulatory arbitrage.

New regulations should:

- Not cover all possible states of nature but rather provide automatic stabilizers for the financial system in general terms.
- Strengthen incentives that improve the disciplining forces of competition.
- Discourage “short-termism” and promote a medium to long-term attitude of financial agents towards success and stability.
- Not prevent financial innovation as it is important for growth and employment.
- Strengthen at the same time the concept of liability and responsibility. It must be clear for those who engage in risky activities that they will be held accountable if these risks materialize.

There are already some important initiatives that provide some guidance for consistent regulatory standards on an international basis:

- The G20 has approved a set of international standards and codes for a sound regulatory framework. However, implementation is lagging behind.
The Financial Stability Forum has already developed recommendations for the resilience of markets and institutions that have caused the financial turmoil.

**Areas of concern that need to be addressed to combat the crisis:**

There are mainly five areas of concern that should be addressed to strengthen the institutional framework for the financial sector.

**Risk management of banks:**
Both bank management and supervisors will have to play a more active role in scrutinizing risk management practices (internal checks and balances, clear lines of responsibilities, etc.), especially with regard to off-balance sheet entities and structured products. This should hold true not only in times of crisis but maybe even more important in good times when risks are less obvious.

**Management of liquidity risk:**
Management of liquidity risk: Bank management should enhance their liquidity management practices to address the liquidity risks in their day-to-day business along the line of the "Principles for Sound Liquidity Risk Management and Supervision" provided by the Basel Committee.
Credit rating agencies:
Rating methodologies failed to capture risks embodied in structured products and investors relied too heavily on those external ratings. Rating agencies should enhance their transparency and should comply with relevant codes of conduct. More differentiated rating systems for structured products should be adopted. Conflicts of interest are to be avoided which are in particular acute when a rating agency also offers consulting services.

Valuation, disclosure and accounting:
Weaknesses in accounting standards and gaps with regard to valuation of structured products contributed to the current crisis. Banks will have to develop robust pricing, risk management and stress testing models and improve disclosure practices. Supervisors and accounting standard setters should advance the transparency and the disclosure standards for off-balance sheet vehicles. They should further reassess the valuation of assets, with a special focus on the mark-to-market approach given its potentially procyclical effects.

Strengthen capital adequacy:
Supervisors did not adequately account for the risks associated with new complex financial instruments. Some financial engineering in recent years focused on repackaging weak credits into high-rated securities, receiving a favourable risk weighing for capital adequacy standards. The respective prudential norms and rating schemes should be reassessed also with a view to make the financial instruments less complex. The O and D business model of financial intermediation should not disappear but it should become more transparent. It should also be
considered whether the originator should always keep a certain percentage of an offloaded credit package on the own balance sheet. In order to increase the capital buffers that banks need to hold with regard to illiquid structured products and off balance sheet activities, the capital adequacy provisions within the Basel II framework should be also enhanced in these areas.

Commodities regulation
Open-market price discovery and price risk management have traditionally been seen as the main benefits that commodity futures exchanges would provide to developing country users. By reducing price risk, hedging on commodity futures exchanges was also seen by some as an alternative to supply management under international commodity agreements. Meanwhile, commodity exchanges have come to assume a broader developmental role as their utility for developing countries has increasingly been seen as removing or reducing the high transaction costs faced by entities along the commodity supply chains (UNCTAD, 2007b). Given that the financialization of commodity futures trading has made the functioning of commodity exchanges increasingly controversial, the question that the current financial crisis poses is how the functioning of commodity futures exchanges can be improved in such a way that they can fulfill their developmental role. In trying to answer this question, it is useful to look at regulatory issues regarding commodity futures exchanges _per se_, before addressing broader international policy measures.
Regulation of commodity futures exchanges

Most commodity futures trading is executed on exchanges located in the United States, the regulation of which is mandated to the CFTC. Commodity exchange regulation has to find a reasonable compromise between overly restrictive limitations on speculative position holdings, which could impair market liquidity and reduce the hedging and price discovery functions of commodity exchanges, and overly lax surveillance and regulation, which would allow prices to move away from levels warranted by fundamental supply and demand conditions and, thus, equally impair the hedging and price discovery functions of the exchanges. Abuse of futures trading by speculators is addressed through the concept of “excessive speculation” defined as trading that results in “sudden or unreasonable fluctuations or unwarranted changes in the price” of commodities underlying futures transactions. To limit the amount of speculative trading, the CFTC has set speculative position limits, which define the maximum position, either net long or net short, in one commodity futures (or options) contract, or in all futures (or options) contracts of one commodity combined, that may be held or controlled by one person other than a person eligible for a hedge exemption.

While it is often held that commodity exchanges have generally functioned well, the recent very sizeable price changes, occurring sometimes within a single trading day, have given rise to greater controversy regarding the appropriateness of regulation. This controversy relates to concerns of both the adequacy of information that the CFTC is mandated to collect and the restrictiveness of regulation regarding financial investors relative to that imposed on participants...
with genuine commercial interests. The need for tighter regulation has been discussed mainly under the “swap dealer loophole”.

The “swap dealer loophole” has played a particularly important role in the current debate on regulatory changes of the CFTC’s regulatory mandates. This is because the greater involvement of financial investors in commodity futures trading has significantly increased the positions that swap dealers hold in commodity futures contracts. Swap dealers typically sell over-the-counter swaps to their customers (such as pension funds buying commodity index funds) and hedge their price exposures with long futures positions in commodities. Swap dealers are generally included in the category “commercial traders” as they use commodity exchanges for hedging purposes. This has allowed them to be exempted from regulation regarding speculative position limits. But contrary to traditional commercial traders, who hedge physical positions, swap dealers hedge financial positions.

Several proposals have been advanced on how to close the swap dealer loophole. For example, the Kansas City Board of Trade proposes addressing the index fund hedge exemptions by limiting their total direct or indirect futures hedge position to a percentage maximum in the contracts with a remaining maturity of one or two months, thus creating an incentive to spread the total position across several months and ease position concentration. It also suggested changes to the definition of a bonafide hedger and a related bifurcation in margin requirements between those that have true commercial hedge positions and those that hedge financial positions, as well as to alleviate strains to finance margins by accepting commercial agricultural collateral (warehouse receipts, etc). Particularly these last two changes would tend to improve the functioning of commodity exchanges with
respect to participants with truly commercial interest. Given the global character of commodity futures trading and the fact that through trading arbitrage some contracts involve the jurisdiction of regulatory authorities in more than one country, international collaboration of regulatory agencies is required. Such collaboration would involve not only the sharing and publishing of information, some of which is already in place, but also more enhanced cooperation and greater harmonization in trading supervision.

It would appear particularly urgent that exchanges whose legal basis is London provide data on positions by trader categories similarly to those that the CFTC has made publicly available for some agricultural products through its COT supplementary reports. Moreover, the product coverage of these supplementary reports would need to be enlarged. Product coverage has remained limited because for many commodities traded on US-exchanges look-alike contracts can be traded in London. As a result, data on positions on US exchanges provide only a partial picture of the total positions of traders that are active on both the United States and London exchanges. Moreover, it would appear that in the absence of such data for Energy products, legislation enacted in the United States to address the London loophole will fail to be effective unless similar data on positions taken on (Intercontinental Exchange) ICE will be available.

**International policy measures**

In addition to regulatory issues, the financialization of commodity futures trading confronts the international community with the question as to how supply-side measures can address excessive commodity price volatility. This issue is of
particular importance for food commodities because current grain and oilseed stocks are at historic lows so that any sudden increase in demand, or a major shortfall in production, or both, will rapidly cause significant price increase. Hence, physical stocks in food commodities need to be rebuilt urgently and adequately sized to moderate temporary shortages and to buffer sharp price movements and to make speculation much more risky and expensive. Holding large inventories around the world has often been judged economically inefficient. In the light of the crisis and the role of financial "investors" this position is no longer convincing.

Obviously, the world needs a new global institutional arrangement consisting of a minimum physical grain reserve to stabilize markets, to respond effectively to emergency cases and humanitarian crisis and an intervention mechanism. Intervention in the futures markets should be envisaged as soon as an existing global institution or a "global intelligence unit" considers market prices to differ significantly from an estimated dynamic price band based on market fundamentals. The global mechanism should be able to bet against the positions of hedge funds and other big market participants and would assume the role of "market maker".

Needless to say, adopting such a mechanism would commit a public agency to second-guess market developments and as the agency would need to bet against the positions of hedge funds it could itself become a target for speculators, considerations which would have to be addressed in its eventual design.

If a virtual reserve and intervention mechanism could be made to work satisfactorily it would not make more physical commodities available on markets,
except for emergency situations. Given that the historically low level of inventories was one determinant of the abrupt price hike of food commodities in early 2008, the question remains how incentives to increase production and productivity could be fostered in developing countries, particularly in food commodities, including through a reduction in trade barriers and domestic support measures in developed countries.

Weak risk and liquidity management frameworks specifically, management and supervisory boards of the financial institutions did not live up to their ultimate responsibilities as regards risk management; risk management models did not keep pace with the increasing complexity of financial instruments and did not properly take into account the potential illiquidity of some market segments; the models and assessments of the rating agencies and external auditors failed to adequately evaluate the financial risks attached to financial innovations.

No serious attempts were made by supervisory authorities to stem against the trend of searching for yield that accelerated financial innovation in good times; no adequate monitoring systems were in place in particular as regards ultimate exposure to mortgage backed securities and other new complex structured financial products and as regards off-balance sheet entities.

**Recommendations:**

The subprime crisis and the ensuing financial meltdown unleashed a remarkable degree of careful study of proposed regulatory responses by academics, voluntary
groups, governments, international institutions and Basel institutions such as the Financial Stability Board and the Basel Committee on Banking Supervision. On the basis of this advance work, the US Treasury issued its conclusions in its June 2009 *Financial Regulatory Reform: A New Foundation* as to what reforms should be enacted by the US Congress. Some proposed reforms were already watered down to meet known or predicted Congressional objections. Nevertheless, since the publication of the US Treasury’s proposed reforms, the Congressional process has already demonstrated a tendency—under the combined influences of heavy lobbying, interest group politics, and Congressional reactions to the changing themes and revelations of the twenty-four hour news cycle—to remove many of the proposals advanced for reform, including some that survived the G20 international process. As Mervyn King, governor of the Bank of England, put it, “To paraphrase a great wartime leader, never in the field of financial endeavor has so much money been owed by so few to so many [and] so far with so little real reform. Reports available at this writing include publications by several Basel institutions (the Financial Stability Board as well as the Basel Committee on Banking Supervision), three leading private sector groups (Group of Thirty, Institute of International Finance, and Committee on Capital Markets Regulation), and to a limited extent the US Treasury, in its previously discussed Blueprint and its proposal on behalf of the Obama administration to the US Congress. In the UK, the Financial Services Authority (FSA) published a report to the Chancellor of the Exchequer by the FSA’s Chairman, Lord Turner. The European Commission published a report of its High Level Group on Financial Supervision in the EU, referred to generally as the de Larosière Report after the Group’s chairman, Jacques de Larosière. Many of
the proposals of these groups are discussed below, but at the outset it is worth expressing some skepticism about broad arguments against the entire process of securitization that are sometimes expressed.

A. Securitization

Any sensible reform of securitization requires recognition of the value of securitization. This financial innovation has been an important technique for financing enterprise in the US since at least 1980. It is heavily used by US business for financing current operations (for example, securitizing accounts receivable in order to improve cash flow). The use of securitization for financing home mortgages seems to some commentators to be a relatively recent innovation. But it has been used by government-sponsored enterprises such as Fannie Mae and Freddie Mac for many years. The positive results of securitization included not merely diversification of risks beyond the banking sector but also increased availability of funds for housing, lower costs and more efficient use of capital—at least until securitization contributed to the international financial crisis. Moreover, as the IMF emphasized in its September 2009 Global Financial Stability Report, a recovery in loan securitization markets, which had collapsed in the recent financial crisis, is “critical” to economic recovery.

B. Securitization in Housing

Not only is securitization in general a useful financial technique, but it is a particularly useful financing technique in the real estate sector and therefore should not be prohibited. Putting aside for one moment the subprime problem,
securitization has been an important and highly desirable innovation in the use of capital markets to finance purchases of homes. Some decades ago virtually all financing of individual home purchases in the US was provided from within the local community. Not only was that an inefficient arrangement, but it was also unfair because poor people in lower income areas found home financing hard to obtain and unduly expensive. This condition in turn led to a rapid growth of securitization of home mortgage loans, in part due to inefficient government subsidy and guarantee programs. It also led to the rise of large, implicitly subsidized but privately owned GSEs, such as Fannie Mae and Freddie Mac. These enterprises popularized securitization of home mortgages. Indeed, until relatively recently, these GSEs were expanding their capacity to guarantee and securitize mortgages to much larger levels, presumably in order to deal with the impact of the subprime problem on the housing industry but also in order to increase the volume of their business. The IMF has made a strong case that recovery of securitization markets, especially in the US, is “critical to limiting the real sector fallout from the credit crisis amid financial sector deleveraging pressures. Thus, as suggested below, the challenge is to make regulatory changes to prohibit or discourage the abuses that led to the subprime crisis.

C. Off-Balance Sheet Entities

The feature of securitization that has received the most criticism is the use of off-balance sheet entities, referred to as Special Purpose Vehicles (SPVs), such as SIVs and conduits. SIVs, which play a key role in the subprime meltdown, are by design poorly capitalized and often highly leveraged. But it would be a mistake to prohibit their use. The press has popularized the notion that these
entities function as part of a “shadow financial system,” but that is a distortion of reality. In truth, everyone in the financial world either knows or can easily determine the sponsoring bank for any SIV.

An SIV's purpose is to create a bankruptcy firewall between the mortgage loan originator and the investor, so that an investor cannot bring an action against the originator for nonpayment of principal and interest by the original mortgagor. In the jargon of finance, SIVs involve “bankruptcy remoteness.”

The elimination of off-balance sheet entities would likely put an end to securitization even for uncontroversial uses because the securitization technique depends upon creation of bankruptcy-remoteness. Perhaps a bankruptcy firewall seems unfair to the investors, but investors who did any “due diligence” would be well aware of the firewall when they bought the securities. Indeed, even assuming that securitization could occur without the bankruptcy firewall feature, the return to the investor would likely have to be lower to compensate the originator for the greater risk incurred. Certainly, it is a financial truism that on average the higher the return, the higher the risk. Investors, both in the US and Europe and even in China, were attracted by the higher return but chose to ignore that higher risk until they suddenly found the prices of their securitized mortgage investments falling.

In view of the widespread use of securitization in financing a wide variety of “automobile loans, credit card receivables, trade receivables, home equity loans, leases of real property or equipment (e.g., airplanes), education loans, junk bonds, boat loans, and even oil or gas reserves,” it would be unwise to take steps to undermine the securitization technique merely to deal with problems arising in the mortgage loan market. Rather, it would be wiser to deal directly with the abuses that have arisen, for example, in the subprime mortgage field and/or the
consumer mortgage origination field.

D. Covered Bonds

An alternative to securitization of the type that led to the subprime crisis is the covered bond. The covered bond certainly has been a success in some other countries. This financial instrument, which is the principal way in many countries (such as in Germany) to raise money in order to fund mortgage loans for housing, involves keeping the loans on the bank’s books, rather than selling the loans. This financial instrument, referred to in Germany, where it is today most widely used, as a Pfandbrief and more generically in the US as a covered bond, has a history going back several centuries. It is in effect an MBS. However, it is also an obligation of the originating bank, which keeps the assets on its books and therefore does not shed its liability for principal and interest, as in the case of securitization. Because the holder has a priority claim to the entire assets of the bank as well as to the cash flow of the mortgage loans, it is a highly rated instrument on which defaults are rare. It has become so popular in Germany that it constitutes 25 percent of the entire fixed income market in that country.

Both the Treasury and the FDIC sought to promote the covered bond as a substitute for securitization in the last year of the Bush administration. But the covered bond seems to have fallen off the Treasury agenda in the Obama administration, though it remains popular in Europe and in Canada. The FDIC in its role of deposit insurer has thus far limited its approval of covered bonds by insured banks to 4 percent of bank assets, no doubt because the priority accorded covered bondholders necessarily reduces the availability of assets of insolvent banks for payment of insured deposits in the event of insolvency.
E. Capital Requirements

The key issue for capital adequacy regulation with regard to securitization is whether banks maintained sufficient capital for off-balance-sheet exposures, whether contractual or implicit. By “implicit” exposures, is meant that a number of banks took SIV assets back onto their own balance sheets for reputational reasons. In the international regulatory reform process, countries quickly converged on the idea that off-balance sheet exposures should be treated the same as on-balance-sheet exposures with regard to the amount of capital required. Achieving this consensus was not a major point of contention, since securitization of mortgage loans came nearly to a standstill during the worldwide financial meltdown and therefore the question of the consolidation of on- and off-balance sheet exposures would have little immediate consequence.

However, that consensus has not yet been translated into law and regulations in most countries. Since the subject is capital adequacy regulation, an amendment to the Basel agreements will be required. Coming up with a Basel III or a substitute for such an agreement can be expected to be contentious and time-consuming. Indeed, many issues that would have to be resolved, even in the US, could delay the resolution of many capital adequacy issues for some time. Therefore, from the standpoint of the issues that arose in the initial subprime crisis, it is important to nail down in law and regulation the proposition with regard to equal treatment of on- and off-balance sheet exposures, at least for securitization. Both US political parties seem to be in agreement on that principle. The Bush-period President’s Working Group, in its interim report in early 2008, recommended that regulators
"adopt policies that provide incentives for financial institutions to hold capital and liquidity cushions commensurate with firm-wide exposures (both on and off-balance sheet) to severe adverse market events. The Obama administration has adopted a similar approach, emphasizing the central importance of capital adequacy requirements.

With regard to this issue, of whether the capital requirements for a bank should be any different just because a bank puts assets in an off-balance sheet entity, it is important to understand that it was precisely the advantage of securitization from the standpoint of the banks under the Basel approach (specifically, Pillar I of Basel II) that banks could hold less capital through the use of off-balance sheet vehicles even though they sponsored the off-balance sheet entities. Under Basel II, a new Pillar II (complementing Pillar I on capital adequacy) gave national supervisory agencies discretion to increase capital requirements of particular banks, but those regulatory agencies generally failed to use the discretion afforded by Pillar II. Indeed, the US has not even formally signed onto Basel II.

The fact that negotiating a successor agreement to Basel II will be time-consuming and doubtless difficult suggests that it would be wise, at least for the US, to put into place definitive rules establishing the capital adequacy parity of on- and off-balance sheet exposures in securitizations. Securitization has a number of attributes, including bankruptcy remoteness that should be sufficient to help securitization markets rebuild as the major economies recover from the present recession.
F. Transparency

Whatever the best answer to accounting for off-balance sheet entities may be from the standpoint of bank regulation, securitizations necessarily involve securities and therefore the question of transparency for the benefit of investors should be faced. One issue with regard to the subprime crisis is whether the relationship between the originating financial institutions and the off-balance sheet vehicles was sufficiently disclosed to investors. The European banks that bought the subprime securities surely knew quite well in general what was involved. If the bankers involved are to be faulted, it is for greed or obliviousness to risk, not for stupidity or for ignorance in the use of SIVs and conduits. Without focusing on the incentives of the individuals involved, it is difficult to understand the carelessness towards risk seen in many of the purchasing banks, especially those that later had to be bailed out or merged or given massive infusions of capital. Nevertheless, securities laws require certain disclosures, and one can be confident that there will be litigation under the securities laws, at least in the US, based on nondisclosure or fraudulent disclosure with regard to subprime securities.

One transparency question is raised by the possibility that some originating banks entered into undisclosed contractual guarantees of securitized mortgage loan issues. The failure to disclose these contractual guarantees did not hurt the investors in the securities directly, though it did mislead and often hurt investors in the securitizing banks. But such cases do illustrate the possibility that the use of off-balance sheet vehicles coupled with undisclosed contractual guarantees was more a matter of form than economic substance, and should be a concern of bank
regulators (because of the enhanced risk to the banks) and perhaps a concern of securities regulators as well. One obvious recommendation is that originating banks should be required to consolidate off-balance sheet entities for reporting purposes (and not just for calculation of capital adequacy).

G. Credit Rating Agencies

Perhaps the feature of securitization that has received the most public attention in the US is the granting of AAA (triple A) ratings by the rating agencies, such as Standard and Poor’s, Moody’s and Fitch. These ratings turned out to be wildly optimistic in a large number of subprime mortgage loan securitizations, and the ratings of these agencies are often considered a major causal factor in the subprime crisis. Hence, the credit rating agencies are a key focus of many proposals for reform.

A number of regulatory issues are involved here. For example, charges have been made of conflict of interest because it is the issuer, not the investor who pays for the ratings. The fact is that a rating has value to investors, but nonetheless a subscription model under which institutional investors pay on a calendar basis for ratings was apparently abandoned by credit rating agencies, decades ago. Economists may say that ratings are public goods, but until some public means of paying for ratings emerges, payment by issuers is a solution, even if perhaps a second-best or partial solution.

A more immediate set of concerns is that in recent years, rating agencies have generated a large proportion of their revenues by their consulting services. As part of their consulting services, rating agencies give issuers advice on how to
qualify for higher ratings. And rating agencies certainly help issuers to structure their offerings to obtain higher ratings by advising on various kinds of what are called “credit enhancements.”

This advisory activity, which has been quite profitable for credit rating agencies, leads to conflict of interest issues when the credit rating agency then goes on to rate a security that has been structured following the advice of the agency. The SEC consequently issued a rule to the effect that any agency that has acted in an advisory capacity on a securitization may not also rate the securities in that securitization.

Perhaps the most problematic aspect of ratings is that an investment grade rating for securities is required by statute for some kinds of institutional investors, such as banks and pension funds, to buy the securities (at least in the US). A substantial number of US statutes and regulations rely on credit rating in one way or another. In effect, regulation has favored the outsourcing of due diligence to rating agencies, which ideally would be a prime activity of investors. Thus, both the originating bank, which is presumably able to charge a higher interest rate, and many US institutional investors, who need high ratings to buy the security at all, have a vested interest in rating agencies awarding high ratings. It is perhaps not surprising, then, that many buyers do not bother to incur the expense to do their own due diligence.

In a partial step toward eliminating the influence of credit ratings in the regulation process, the SEC has proposed to eliminate the use of credit ratings from private credit agencies in its own regulations and procedures. However, the SEC has not yet adopted that proposal. A bill that would eliminate references to ratings in certain statutes was approved by the House Financial Service Committee but the
agencies could apparently nevertheless make use of credit ratings in their proceedings if they chose to do so.

The use of ratings for official SEC purposes has been criticized on the ground that making ratings legally determinative leads to ratings inflation and discourages due diligence by purchasers. A tendency of investors to rely on ratings in lieu of doing their own due diligence certainly played a role in the subprime fiasco even where the ratings did not provide a regulatory safe harbor, and official use by the SEC of ratings could be expected to carry that tendency even further. Furthermore, using ratings from private sector agencies as a basis for regulatory rules and decisions amounts to a delegation of governmental power to private bodies. Yet Basel II relies on credit ratings in several respects, and therefore the official use of credit ratings is likely to resurface as an issue.

In May 2008, the EU Committee of European Securities Regulators (CESR) proposed an “international CRAs standard setting and monitoring body to develop and monitor compliance with these international standards . . . using full public transparency and acting in a ‘name and shame’ capacity to enforce compliance with these standards via market discipline.” The new body would be formed as an international body or, failing that, at the EU level. Meanwhile, the European Commission is considering EU legislation based on an IOSCO (International Organization of Securities Organizations) code.

This appears thus far to be an example of a rush to regulation without having first identified specific shortcomings to be addressed. It is ironic that the EU member securities regulators themselves are making these proposals since they presumably had the responsibility themselves to regulate the MBSs markets.

Another problem with ratings is that they do not address several important issues.
First, since rating agencies rate the issuer’s capacity to pay principal and interest when due, the probable price performance of the securities is largely ignored, despite the fact that under mark-to-market accounting a substantial portion of the losses experienced to date have involved downward price fluctuations, not defaults on the underlying mortgages loans. Quite without regard to defaults on residential mortgages, price performance plays a major role in investors’ results because when market interest rates rise, the price of fixed income investments falls (though hedging may minimize such losses).

Second and related, the rating agencies do not address liquidity in secondary markets. The seizing up of various credit markets in the summer of 2007 underscores the importance to investors of liquidity. As previously discussed, the seizing up of commercial paper markets used by SIVs to fund purchases was the trigger for the onset of the crisis. The liquidity vulnerability stems directly, of course, from the fact that the business model of banks is based, as previously discussed, on borrowing short and lending long, a practice carried to extremes in the short-term commercial paper financing of SIVs.

And third, in an effort apparently to be—or at least to appear to be objective, rating agencies rely heavily (and perhaps in some cases exclusively) on past payment experience with regard to similar securities. Since subprime mortgage securitization (other than by the GSEs) is largely a phenomenon of the several years prior to the crisis, which was a period in which US real estate prices were rising steadily, the ratings failed to capture the lifetime risk in the underlying mortgages. It is therefore not surprising that the five-year default rate on securitized products rated by Moody’s just above the investment grade qualifying level (Baa) was ten times higher than on corporate bonds at the same
level. As defaults on residential MBSs rose, credit rating agencies began to
downgrade other outstanding securitized MBSs, causing widespread decline in
prices of such securities. All financial institutions holding residential MBSs had to
book widespread losses under the mark-to-market principle.

H. Underwriting Standards

Another issue that has captured great public attention in the US is the
lax underwriting standards at the stage of the initial mortgage loans to subprime
buyers.

Not only did many of the lenders purposely fail to exercise ordinary banking
prudence, but fraud by both borrowers and lenders was undoubtedly part of the
overall problem. But perhaps most of the problem arose from the persistently
skewed incentives of the parties involved in securitization. We can be sure that
the US administration and the US Congress will be focused on this aspect of
subprime mortgages, and the Obama administration has proposed a plan to create
a CFPA that would be able to confront such issues. The activities of such an
agency could prove crucial to the re-launching of securitization activity in the
consumer real estate market.

It was, of course, the increasing defaults by US homebuyers, who bought homes
that they could not in the end pay for, that triggered the subprime crisis. The
general disposition in the US domestic political process has been, perhaps
reasonably in view of the extensive anecdotal evidence of lender fraud and of no-
documentation and low documentation loans, to blame the lenders rather than the
borrowers.
Here the European perspective is instructive. In Germany and in some other European countries, it is difficult to obtain financing above 60 percent of a home’s value, and this fact is widely accepted by the citizenry. The US focus on affordable housing is socially praiseworthy and politically popular, but it was also the breeding ground for the subprime crisis and for such setbacks as the collapse of the GSEs.

Effective reform’s approach in Regulatory mechanism by USA has become a case study for various countries, the reforms of regulatory includes:

1. Expand the Federal Deposit Insurance Corporation bank resolution mechanism to include non-bank financial institutions;
2. Ensure that a firm is allowed to fail in an orderly way and not be "rescued";
3. Ensure taxpayers are not on the hook for any losses, by applying losses to the firm's investors and creating a monetary pool funded by the largest financial institutions;
4. Apply appropriate checks and balances to the FDIC and Federal Reserve in this resolution process;
5. Require stronger capital and liquidity positions for financial firms and related regulatory authority.
6. Law investigations, judicial and other initiations started their own course of action which lead to several litigations, penalization etc.,

Where as in other part of the world including India :-

1. Monetary policy intervention has been used as an effective tool
2. Introduction of Stimulus packages to keep up the economic growth.
3. Provisioning to Risky assets exposure by the banking system.
4. Increased CRR ratio and Liquidity tinkering through monetary policy
5. Thrust on Capital Adequacy of Banking System.
6. Focus on Low Cost Affordable Housing and sops to such borrowers through tax benefits.
8. Making the Country’s Financial Institutions size wise big to prevent any crisis on the part of exodus of Foreign Investors in the events of crisis.
9. Proper Credit rating of borrowing individuals and corporates.
10. Checks and Balances at each and every level
11. Increased supervision through review’s by RBI on Banking and Non Banking Finance Companies.
12. Investor Education Programs and Financial Literacy
13. Whistle Blower Policy

Conclusion

The current global financial distress and the economic downturn pose challenges of a significant and unprecedented nature to the ECB, other central banks and policy makers around the globe. During the financial turmoil the euro area, the monetary union and its institutional set up have proved their resilience and the capacity to act decisively and promptly. National measures have been co-coordinated in a pragmatic manner with a view to enhancing their effectiveness through mutual reinforcement. All this is not self-evident. We should not forget how Europe would look today without the euro. The euro area countries would be significantly worse off. Multiple crises would arise simultaneously: currency crises would go hand in
CHAPTER VII REMEDIES TO OVERCOME SUB PRIME, GLOBAL FINANCIAL CRISIS AND RECESSION

Hand with banking crises and real economy disruptions at country level, potentially ending up in political tensions between countries. By eliminating the exchange rate channel, the euro has mitigated the risk of contagion stemming from national economic or financial crises. In this sense, the euro has been a very important stabilizing element in difficult times.

Though the financial crisis (turned into an economic crisis) is far from being solved, and no obvious solutions can be given until the last part would have been played, it is mandatory that the international community (governments, international financial institutions, market regulators, monetary authorities) must cooperate. Nevertheless, a few possible approaches can be outlined. First and foremost, it is obvious that the international community has to come to terms with the fact that the functioning of the global economy will be set in a new frame, and a new economic order will exist and therefore they should agree on the principles regarding the coordination of economic and financial processes: enhancing prudential supervision and regulations of risk management, promoting transparency and accountability, encouraging savings and investments as opposed to consumption and waste, thus making resources available and granting loans to small and medium firms that can launch economic growth, employment and productivity.

Moreover, on a wider level, because of the high level of contagiousness of markets, the international financial institutions should agree on:

- procyclical policies,
- enforce global accounting standards,
- regulating derivative markets and clearing systems.
But all these long term measures can be considered only after the liquidity problem has been solved. The core issue of the liquidity problem is now the lack of credibility blocking the inter bank markets, affecting the availability of loans, the fuelling of funds into the economy, and economic downturn. For these reasons, we believe that what mainly distinguishes the present crisis from the previous ones is mainly the lack of credibility of financial markets and the high contagiousness. Therefore past approaches and solutions might be now either inappropriate or may be reconsidered in order to meet the present needs.

Dealing with credibility might be a sensitive issue given its complexity due to behavioral and psychological aspects of risk management that are embedded (either risk acceptance or aversion), besides economic ones. Nevertheless, a correct approach of the liquidity problem is essential because it allows the proper functioning of financial markets, the flow of capitals and the up-swing of the economy.

The present crisis rooted in the sub prime mortgage market is the result of a number of risky and irrational economic behaviour pursued in time by financial institutions, public decision makers and individuals, disregarding the risks and economic consequences that might have occurred by spreading through the open markets. The accumulating determinants spread by contagion to the whole world, eventually affecting the global economy and living standards. Still, a number of lessons can be learned. Firstly, the crisis should not be treated emotionally but rationally, setting up a smooth restoration of macroeconomic balance. Consumption should be restored cautiously and preconditions for savings should prevail in order to mitigate the lack of external funding. Secondly, no financial
institutions are "too big to fail" so, prudential supervision of the financial markets should be revisited and adjusted to present conditions. Under these consequences, the fiscal stance becomes very important and public deficits' management should become a priority preventing the fuelling of money supply. Still the question remains: should the state intervene to bail out ailing financial institutions or should the market restore transactions according to its mechanisms and insulate these entities?

The first approach may be considered given the high contagion effects of bank failure on other institutions thus preventing chain spill over of the default effects. The dilemma is even greater because of the high costs borne by tax payers and the burden on public budget. On the other hand, the market approach has more long term profound effects, the solid and efficient financial institutions remain in the system, but the approach could be costly and painful for the intermediation process. Eventually, this is a problem of fine tuning between the state intervention and the market mechanisms in order to diminish the costs as much as possible.

Indeed, the public budget can positively contribute to the solving of the crisis by channeling funds to financially support the small and medium firms, to improve the infrastructure (thus decreasing unemployment, and increasing personal income and consumption) and lower non productive spending. As a consequence, fiscal space can be created allowing sustainable public deficits used to boost the economy.

Last, but not the least, the credibility problem should be at the core of either of the above approaches because the national and as well as the international financial system cannot function, in a global environment, unless its conduct is transparent, accountable and most of all promotes credibility among partners.