

Building a New Financial Architecture

1st Panel: EU Financial Supervisory Architecture

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Introduction

- First, I want to thank the organizers of this Conference. It is very important that all the stakeholders in the Financial System get together and discuss the very relevant issues that are on the Agenda of the Financial Reform.
- Now, let me introduce myself. I am the CEO of Banco BPI, one of the main commercial banks based in one of the “PIIGS”.
- So far, we have not used any kind of Government support and we have the same debt ratings we had in June 2007 from all the three rating agencies.

The Anglo Saxon Financial Crisis

- As we can see from the names in the next slide, we did not have a financial crisis in the “PIIGS” or in the Eurozone or in Continental Europe. We had a big crisis essentially in Wall Street and in the City with consequences for the rest of the world.
- We should let our British and American friends put their houses in order and then see whether we need to introduce changes in the Eurozone financial systems.
- Right now, we should be concentrating our efforts on how to improve the competitiveness of our economies and the social cohesion of our societies.

The Anglo Saxon Financial Crisis

- Northern Rock
- Bradford & Bingley
- Alliance & Leicester
- RBS
- Lloyds/HBOS
- Freddie Mac/Fannie Mae
- Lehman Brothers
- Bear Stearns
- Merrill Lynch
- Citigroup
- Bank of America
- Washington Mutual
- AIG
- UBS
- ING
- Fortis
- Dexia
- Hypo Real Estate
- Commerzbank
- Anglo Irish Bank
- Bank of Ireland
- Allied Irish Bank
- Glitnir
- Kaupthing
- Landsbanking

The Topics

- The European Agenda is what it is and I was invited to talk on this panel about the EU Financial Supervisory Architecture.

So, I will take this opportunity to comment on three topics:

1. The role of the European Banking Authority (EBA)
2. The efficiency of the corporate and bank bond market
3. The economic and social usefulness of Credit Default Swaps

The role of the European Banking Authority

- I agree that EBA can contribute to a better functioning of the single market in preventing financial crisis and managing them if they occur. But the evolution should be gradual.
- It makes sense that EBA develops draft technical standards aimed at removing differences in the national transposition of Community law and establishing a single market rule book. EBA should have powers to ensure the consistent application of Community rules and should play an active coordination role among National Supervisory Authorities in emergency situations.

The role of the European Banking Authority

- However, I do not agree with the attribution to EBA of supervision powers over financial institutions with EU dimension. In fact, real pan-European banks do not exist yet. And the realities of each country are still very different.
- The words of Mr. Laroisière are very wise: “National Supervisors know the banks well, the political authorities have at their disposal a consistent legal framework and taxpayers concerns can be dealt within the democratic framework of an elected government”.

The (in)efficiency of the debt markets

- The Anglo-Saxon financial crisis that started in 2007 has essentially been a debt crisis.
- The lack of transparency and efficiency of the corporate and bank bond market exacerbated the impact of the crisis.
- The distortions of the CDS instrument and the same lack of transparency and efficiency have lately become very visible.
- The effects of the debt markets inefficiencies are felt by the issuers (Governments, Banks and Companies) and by the investors; small investors and small issuers, with less access to information and flows tend to be the most affected.

Why is the transparency of bond prices relevant?

- Bond Prices determine issuing costs for Governments, Banks and Corporates: if the prices are formed in an opaque market, they do not incorporate the true information about default probabilities; the credit risk becomes mispriced.
- Bond prices are used to value all types of portfolios: banks, insurance companies, pension funds, mutual funds, retirement plans; a bad valuation affects the wealth of individuals, companies and the economy as a whole.
- The valuation of portfolios ultimately influences the capital requirements of financial intermediaries: a “bad” valuation gives rise to the wrong amount of capital set aside for the financial activity.
- The economic activity is more and more dependent on the bond market: if it is not efficient, the allocation of resources is also not efficient and the whole economy loses.

Bond Market: How does it work?

- Primary market issuance subject to Issuer financing needs and Investor demand.
- Large financial intermediaries tend to act as market makers but there is no commitment on price or amount.
- Secondary Market Activity Over-The-Counter (OTC): each market-maker updates it's indicative or firm (for small size) price levels on Bloomberg screens or other electronic platforms.
- Poor price transparency for larger size (prices on screen don't always work).
- Most transactions take place on the phone; very few Electronic platforms available.
- No disclosure of Market Activity statistics: prices, amounts traded, number of trades.
- In critical moments, market makers disappear: liquidity becomes itself volatile, valuations become irrational.

Why is the Stock Market different ?

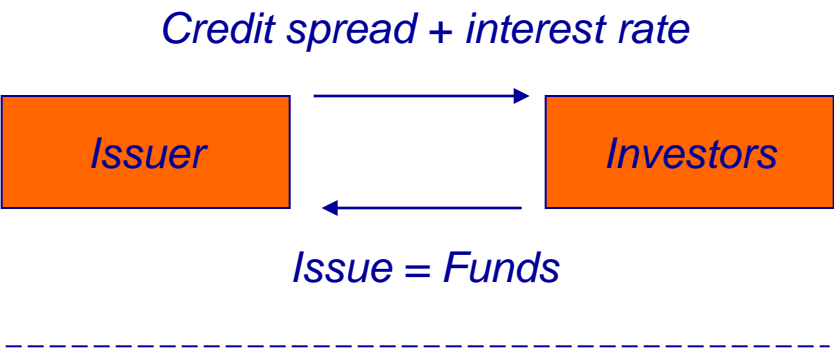
- Only one stock for each company while several bond issues with different characteristics outstanding.
- Higher granularity of market participants including smaller retail clients
- Electronic trading on Stock Exchanges only.
- Full disclosure of intra-day prices and volumes available to all participants.
- Smaller amounts traded easily while in bonds trading multiples can be € 50,000 or even higher

How can this situation be changed?

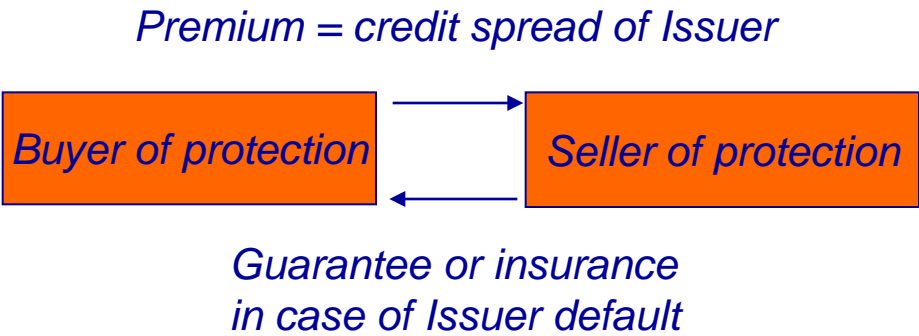
- Establishment of a regulated Exchange for bonds, with similar principles as the Stock Market
- Proposals / Suggestions:
 - Issues > EUR or USD 500 million traded through an Exchange;
 - Disclosure of bid and offer positions at all prices;
 - Full disclosure of Market activity: deals, prices, quantities;
 - Direct interaction between buyers and sellers.

CDS's Dynamics: How does it work?

BOND MARKET



CDS MARKET



The Buyer of protection may or may not have an economic interest on the Issuer. A strong search for protection may drive CDS risk premium up irrespectively of what the Issuer's economic situation is

Reality shows that movements in CDS prices affect the credit spreads of the Issuers.

The CDS market has different participants that create a dynamic of its own. It can be influenced by factors that are external to the Issuer's activity, ultimately determining the Issuer's borrowing costs

CDS's Dynamics: How does it work?

Eventually, the Seller of protection looks for hedging its position with another counterparty which will also hedge itself, initiating a hedging chain.



The interaction between Buyers and Sellers in the CDS Market creates another dimension which is counterparty risk. There is no information on concentration or the size of the hedging chain. A default of a counterparty may bring a disruption that may easily affect the Issuers' borrowing costs.

CDS's Dynamics: How does it work?

- CDS are not traded in regulated exchanges; market lacks transparency:
 - no information on relationship between amounts traded and respective prices;
 - no information on outright hedging vs naked positions,
 - no information on number and frequency of trades.
- Therefore, CDS prices give poor information.

The Export Credit Insurance: a comparison with CDS's

- The mechanics of credit protection is widely used for a long time.
- A good example is the recourse to an Export Credit Agency (ECA):

The ECA also tends to reinsure itself totally or partially with other similar companies, which allows for the risk dispersion.

- These are bilateral contracts with a direct link to a specific transaction (the Credit); the rights and obligations of each party are limited to the terms of that Credit.

The Export Credit Insurance: a comparison with CDS's

Export Credit Insurance	CDS
No leverage: The Insurer has recourse to the borrower up to the amount of the specific transaction being insured.	Potentially ilimited leverage: the Buyer of Protection may or may not have debt of the underlying Issuer; the limit to the amount of protection bought is the amount the market will want to sell.
In case of default, the Credit Owner receives the insured amount gradually, as it falls due.	In case of default, the Buyer of Protection receives 100% of notional at settlement date (once default has been determined).
In case of default, the ECA is responsible for the recovery procedures and retains any recovered amounts.	In case of default, the Seller ("Insurer") receives from the Buyer the cheapest available bond or its cash equivalent as a recovery.

The case against Naked CDS's

- By buying the protection without having any economic interest on the Issuer, the CDS Buyer will lack the incentive to monitor its performance; its trade will work better when the Issuer's credit risk premium underperforms.
- The absence of liquidity and transparency allow for inefficiencies.
- Cash prices react in tandem with CDS prices, affecting the economy of the Issuer.
- The process of protection buying by several market participants may create a self fulfilling prophecy because it influences the investors confidence on the Issuer's ability to fulfill its obligations, which means that investors will be less willing to lend; the Issuer may have liquidity problems that will make the repayment of its debt more difficult and more expensive.
- **CDS's are a speculative instrument that can be used as a hedging instrument. Is it possible to derive any Economic and Social Benefits out of speculation with CDS's?**

