Securitisation must lose the excesses of youth

By Christine Lagarde

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European Union finance ministers, at their informal Ecofin meeting last month, showed that the views expressed by Angela Merkel, the German chancellor, and Nicolas Sarkozy, France's president, in a joint open letter to the EU presidency, were widely shared. The EU ministers underlined the crucial importance of financial stability for the competitiveness of the European economy. Drawing the first lessons from the current financial turbulence, they stressed the need to encourage further the transparency of markets and the responsibility of all actors, at the European and international levels.

While macroeconomic fundamentals in the EU are strong and European financial institutions are sufficiently sound and resilient to weather the current episode of financial market volatility, Ecofin has committed itself to explore ways to tackle the challenges raised by financial innovation. Our next meeting on Tuesday provides the opportunity for a deeper exchange of views. We will also discuss these issues within the Group of Seven industrial nations on October 19. Against this backdrop, I want to offer some considerations to fuel these debates.

Financial innovation, and in particular securitisation using increasingly complex techniques, has developed considerably over the last few years. The benefits of securitisation are undeniable in avoiding the concentration of risks and they should be preserved. Spreading credit risk in the marketplace strengthens the resilience of the financial system and contributes to a better allocation of resources. But the market turbulence also attests to the need for substantial adjustments in the securitisation process. It is time for structured finance to move from the excesses of youth to maturity.

Assessing risks of complex assets has become challenging and responsibilities for doing that are fragmented. We should prevent a situation whereby incentives have biased consequences and market agents can be irresponsible. It is therefore critical to address the issue of unregulated entities that originate loans, the risk of which they immediately pass on to others. By definition, these entities face hardly any incentives for controlling credit risk other than market discipline. This contrasts with regulated banks. For this reason, I believe the remedy is proportionate supervision by banking authorities, as is already the case in a large number of countries.

Rating agencies play a crucial role in the securitisation process. By rating securitisation vehicles, these agencies determine prudential limitations based on data they receive from loan originators. This is an unhealthy situation, however professional the assessment by rating agencies may be. Rating agencies should therefore develop procedures for assessing the information they collect and adopting unquestionable rules to avoid conflicts of interest, including external monitoring. In particular, Europe must give serious thought to submitting rating agencies to the oversight of market regulatory authorities, as is the practice in the US.

Transparency with regard to the actual packaging process of securitisation should be heightened. However, once it reaches a certain degree of complexity, assessing the associated risks may prove to be impossible or too costly. A certain degree of standardisation may therefore be necessary. The various players involved should understand they need to move in that direction.

Finally, the liquidity of secondary markets for such complex securities can disappear very quickly. Both rating agencies and investors should be able to assess this liquidity risk. Rating agencies should enhance their methodology for assessing structured products so as to capture liquidity risks. The use of different scales for companies and for structured products could, for example, address this concern.

In Europe, regulations initiated by the Basel committee have served us well. In the EU, Basel II will become the common standard for banks to manage solvency risk. We will promote the use of these rules in all financial markets. Looking beyond, the recent turbulence reminds us how vital sound liquidity risk management by banks is. That risk has undergone profound changes as a result of the massive shift in banks' funding from deposits to markets. The time has come to update international standards related to bank liquidity, basing them on stress scenarios. The Basel committee should be tasked with coming up with new standards and the EU should formalise these standards in a directive.

The current turbulence also highlights the need for greater transparency in the financial system. Through their interactions with hedge funds, banks are exposed to risks borne by complex, shifting structures that operate at times in a rather opaque fashion. We should maintain the efforts already under way to foster the adoption of a code of conduct and to strengthen procedures for monitoring banking risks. In broader terms, the banking authorities and central banks should consider working with the industry to modernise current statistical tools so that they better perform their task of tracking macro-financial developments.

France is committed to working with supervisors and consulting all stakeholders, especially the financial and banking industries. Indeed, the point is not to introduce additional standards or regulations per se: what we want are concrete proposals to tackle the challenges raised by financial innovation while ensuring market efficiency. With that aim, we need the feedback and co-operation of the private sector.

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