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PUBLIC STATEMENT

The 16th meeting of the Market Participants Consultative Panel

The Market Participants Consultative Panel held its 16th meeting on 9 April 2008 in Paris.

The discussion was facilitated by CESR Chairman Eddy Wymeersch and was dedicated to (1) the effects of the recent market turmoil, including lessons to be learnt and to (2) the role of rating agencies, taking into account the public consultations by CESR and IOSCO in this area. Furthermore, members discussed the post-ECOFIN roadmap and the CESR work programme for 2008.

1. Discussion on market turmoil

The discussion about this topic was introduced on the basis of two presentations, given by MPCP-members.

The first presentation started from the point that the past years proved to be an excellent climate for financial innovation, illustrated by examples such as: segmentation of risks, securitization and risk transformation. Innovations are perceived as beneficial for the industry and society at large. Parts of innovation might be risky, but industry should make an effort to improve the handling of risks. Taking risks (and manage these accordingly) is inherent to the financial industry. According to this view, the main trigger for the turmoil lies in the dramatic shift in US monetary policy in earlier years when interest rates were lowered to a very low level. When the turmoil emerged, partly due to a lack of understanding of the innovations, liquidity in the market froze and banks started to hoard liquidity, among others by liquidating assets which in turn led to a fall in asset prices. The addition of liquidity to the market by central banks was helpful, but did not work out due to additional corporate incidents in the market.

At the current stage of the turmoil, fears in the market might be exaggerated according to this view, in particular for the EU which is more diversified and where companies have in general solid balance sheets. It was stated however that 80% of 'toxic assets' are held by European banks. Lower visibility of the turmoil in the EU might have to do with better management of corporate communications. In comparison to the EU and based on past experience with other financial crises, it was noted that US banks mainly rely on solving the impact of the turmoil on an individual basis, ignoring the impact of individual behaviour of firms on the financial system as a whole, without any collective efforts how to address the impact of the turmoil. In conclusion, the current lessons to be learnt are, according to this view: avoidance of an overreaction in regulatory response, a need for regulators to learn more about asset price bubbles, a possible review of accounting rules and a stronger focus on stress testing.

The second presentation underlined the fact that the roots of the turmoil were already visible in late 2005, when housing prices peaked. This was largely ignored in 2006 due to even further rising prices. In 2007 however, the quality of mortgage loans deteriorated, the number of foreclosures rose, leading to growing reluctance of banks to provide credit and a general decrease in risk-



appetite. The need to assess all loans on the books of a financial firm in every aspect on a continued basis was qualified as a daunting task.

On the economic outlook, it was noted that central bank liquidity indeed had reduced existing pressures in the market, but it was estimated that it will nevertheless take quite some time for the economy to recover from the turmoil. In this view, the lessons to be learnt are in the area of establishing regulation in the area of mortgages and adaptation of the originate/distribute model for securitization.

With regard to the role of rating agencies, it was noted that the transfer from Basle I to Basle II provided banks with incentives to invest in AAA instruments. In general, more awareness and understanding is needed that AAA ratings for different products do not have the same meaning.

In the subsequent discussion, one MPCP-member pointed out that US law will most likely not permit to explore collective efforts to address turmoil-issues. This position was illustrated by regulatory trends (such as capital requirements, competition rules and mark-to-market rules) which would go against the idea to explore collective efforts to address turmoil issues. As an alternative option, it was suggested to learn from the fall-out of the Japanese asset price bubble in the nineties.

Furthermore, in the context of valuation of financial instruments, the lack of detailed understanding of the composition of financial instruments and the importance of what is evaluated (risks or repayments) was emphasized.

Another member questioned the claim that 80% of toxic assets are held by EU banks and noted in this context the asymmetrical approach by the US FED in response to changes in asset prices ('Greenspan-put'). According to this member, a review of capital requirements and more transparency is needed.

Limited effects of the turmoil were noted in the 'new' EU Member States, unless they are positioned in a less prudent financial condition.

Furthermore, it was suggested: to establish among regulators a think tank to better understand developments in the market and to communicate output with the public, to enhance product understanding of regulators by training and to fit this into the regulatory process, to engage with business schools and to think of a mechanism to facilitate the market in case of impaired price formation.

Based on experience with previous major corporate incidents, one member noted as a common denominator in those incidents that a lot of business was kept outside the balance sheet. When regulatory attention shifted to SPV's, firms moved to SIV's and subsequently to SICAV's in order to organise activities outside the scope of regulatory attention. Chairman Wymeersch responded that the suggestion for an enhanced role of the supervisory board rightly is mentioned and is an issue of corporate governance. Based on personal corporate responsibilities, this member underlined the need for firms to monitor in-depth where counterparties derive their profits from.

Chairman Wymeersch concluded this agenda point by emphasizing CESR activities on rating agencies and CESR's call for more transparency. In the area of accountancy, CESR does not have regulatory responsibility. With regard to a suggestion for a single EU supervisor, the chairman noted that the trend at the political level seems to move into a direction of colleges of supervisors.

Recent developments in the US regulatory framework led to a more open position vis-à-vis foreign broker/dealers and the intention of US authorities to work closely with Canadian and EU authorities in this respect. The recently announced 'US Treasury Blueprint' for US financial supervision confirmed the responsibility of US authorities for regulation of the financial sector and the need for a comprehensible supervisory structure. The recommendations deriving from this blueprint can be devised into short-term, mid-term and longer-term recommendations. In the short-term the expansion of the Presidential Working Group (US Treasury, FED, SEC and CFTC) with a number of agencies with responsibilities in the financial sector, is on the table. For the mid-term, a merger of the SEC and the CFTC is proposed. For the longer term, a more functional approach of the US



supervisory structure was put forward. The Presidential Working Group, the FED, OCC are considered to be among the winners of this plan. The plan however raises issues of balance of powers with the states and underestimates the benefits provided by securities laws in the seventies, such as competitive markets and a big bang in the clearing of transactions. The jury is still out whether this plan will result in a more streamlined or a more complex type of supervisory structure. In response to a question on the likelihood of a swift execution of this plan, it was estimated that not much will happen in the short term. The impact of the plan on the EU/US dialogue was also considered to be limited, although there is always a risk of overreaction, where each reform creates the seeds for the next crisis.

2. The role of Credit Rating Agencies (CRA's)

The subject was introduced by one member stating that some EU-regulators seem to oversimplify the problem of understanding financial products by using 'traffic lights'. According to this member, regulators should explain to a wider audience what AAA means in terms of risk probabilities. Furthermore, concerns were expressed about cliff-effects of (changes in) ratings and the selling process (in this view, the sale of research by CRA's would in particular require additional re-thinking). Caution existed among members about authorisation of CRA's with all liability issues attached to it for regulators. No evidence had been found to date for improper handling of conflicts of interests by CRA's, despite extensive regulatory attention. Risk of reputation might serve here as a countervailing power. There might be market dissatisfaction, but no market failure. The Panel took the position that cooperation between CRA's and regulators on the basis of self-regulation is the future way forward. Hard regulation on the other hand, might slow down the speed of innovation and could have unintended consequences for regulators.

Another member confirmed that CRA's are providing a useful service and regulation is not necessary. In the early years of this century, the approach of comply/explain, annual meetings with CESR and further explanations to individual CESR members, if needed, sufficed. At present however, CRA's did a poor job in product ratings, in particular with regard to the speed of adjustment of ratings. Additionally, improvements in the management of conflicts of interests by CRA's were suggested (in particular in the areas of transparency of fee structure and rotation of teams for monitoring ratings). For the wider audience, the limitations of a rating (no judgement on price or liquidity) should be communicated in a more effective way.

Other bottlenecks identified in the area of rating agencies are: the current market structure of rating agencies with high entrance barriers (amplified by the market practice to require two ratings for a single product), the existing prudential leverage of CRA's due to Basle II, a mismatch between first ratings and monitoring of current ratings, fostered by existing fee structures, a lack of macro-economic views to be taken into account in the rating process, training and turnover of staff and the length of the process to review and/or to change a rating. In response to the on-going IOSCO consultation, the need for a clear definition of a structured product was underlined.

3. Post ECOFIN Roadmap

Chairman Wymeersch highlighted some of the areas derived from the ECOFIN conclusions on how to improve the role of the 3L3 committees in the Lamfalussy approach, such as qualified majority voting and the proposed introduction of an EU mandate in the national mandates of regulators. Recent political discussions indicate that no legislative action will be taken at EU level with regard to the introduction of an EU mandate, but this may require adaptation of national legislation in some jurisdictions. The Chairman added that introduction of rule making powers would seriously strengthen the position of the 3L3 committees, but this would infringe upon the position of Member States and the European Commission. Furthermore, delegation of tasks (to be distinguished from: delegation of decisions) and colleges of supervisors are more likely ways forward to strengthen the role of EU supervision.

4. CESR Work Programme 2008

Members of the Panel were invited to submit ideas for a strategic CESR only work programme for the next years. Chairman Wymeersch called upon Members of the Panel to indicate areas where



CESR is inefficient. In response to a question about the cooperation on MiFID issues, it was clarified that the assessment of the implementation of MiFID will be conducted by the Review Panel and the outcome might facilitate the regulatory dialogue with US authorities. From an operational point of view, the establishment of a Q/A database, discussion of hot topics such as best execution among supervisors active in operational supervision and a future assessment of market consequences were mentioned. In the context of the dialogue with the US, one member noted the wish of US compliance officers to check authorisation of EU counterparties and suggested that CESR might play a facilitating role in posting hyperlinks to local websites of individual CESR members and to lists of authorised brokers and other intermediaries.

5. Any other business

1. Timely distribution of meeting documents and distribution of a list with contact details of MPCP-members (for members only usage) were flagged as ways to improve the effectiveness of the Panel.
2. In view of the expiring MPCP membership of Donald Brydon, Chairman Wymeersch expressed his gratitude to this member for his valuable contributions as a member of the Panel.
3. The next meetings of the Market Participants Consultative Panel are scheduled for the following dates:
 - Paris, 29 September 2008
 - Paris, 11 December 2008 (jointly with CESR Members)