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FINANCIAL MARKETS

Rebuilding trust in the system

Getting the banks to lend to one another is just the first step

BY JAMES LANGTON

AROUND THE WORLD, governments have taken unprecedented actions to restore trust in financial services institutions. But the reforms needed to rebuild faith in the financial system have yet to happen.

At the core of the current financial turmoil is banks losing confidence in each other. Not knowing what horrors lurk deep in industry balance sheets, financial services firms have become nervous about lending to one another, leading them to hoard capital. That is undermining the availability of credit — which is particularly undesirable as the world teeters on the brink of a recession.

"The length and scale of the economic crisis will depend on the speed at which interbank markets return to normal," observes a report from Paris-based **Natixis Securities**. "However, there first needs to be an immediate reduction in banking counterparty risk."

To that end, governments have enacted various bailouts, backstops and bulwarks that aim to restore financial system stability by bolstering banks' confidence in the system. Measures such as troubled asset purchases, guarantees on deposits and interbank lending, and capital infusions are designed to reassure financial institutions that it's safe to deal with one another.

In Canada, such efforts have been modest. There have been no moves to add capital to the banking system and no expansion of deposit guarantees. The **Bank of Canada** has added liquidity and cut rates; the feds have hatched a plan to purchase up to $25 billion in mortgage-backed securities. And the most recent initiative — an insurance plan for wholesale debts announced on Oct. 23 — will put Canadian banks on an equal footing with banks in the rest of the developed world, many of whom have seen lending guarantees introduced in an effort to restore confidence.

(This new facility will be available from early November until the end of April 2009.)

Finally, there are signs that these initiatives are starting to work. Notably, the rates at which banks lend to one another are creeping downward from recent highs, although, as of the end of October, they are far from normal. They remain at levels that indicate ongoing liquidity stress. In a recent report, New York-based research firm **CreditSights Inc.** reinforces the belief that the programs designed to alleviate this stress will eventually work. But, the report predicts, it could be 2009 before these funding costs return to more normal levels.

So, for now, interbank markets remain stressed. Instead of lending, banks in Europe have been hoarding their fresh capital; in the U.S., they are using it to buy weaker rivals.

All of this makes for horrible public relations. The fact that banks are receiving taxpayer assistance, yet aren't delivering the help that the economy needs, can only exacerbate the public backlash against the banks (and the financial services industry, generally) that accompanies the sight of wealthy bankers

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receiving bailouts from taxpayers who are themselves facing job losses and mortgage defaults.

Indeed, that backlash has begun. New York state attorney general Andrew Cuomo has cajoled insurer **American International Group Inc.** to freeze payments to its former CEO and halt payouts from its US$600-million bonus pool, as well as cancel conferences and other junkets. AIG has also agreed to establish a special governance committee to institute new expense-management controls.

Cuomo has also begun an inquiry into executive compensation practices on Wall Street. In a letter to nine large firms that have received capital infusions from the U.S. Treasury's bailout program, Cuomo demands information about the firms' bonus pools, warning that he will have "grave concerns" if those bonus pools have increased following the provision of taxpayer funds.

"In this new era of corporate responsibility," the letter says, "boards of directors must step up to the plate and prevent wasteful expenditures of corporate funds on outsized executive bonuses and other unjustified compensation."

The Treasury program does carry executive compensation restrictions, but they are vague and not particularly restrictive.

The U.S. banking industry is not pleased with this effort to rein in executive compensation. On Oct. 30, the **American Bankers Association** wrote to U.S. Treasury secretary Hank Paulson to complain that banks were being pressured to take capital injections they didn't really need for the good of the economy. As a result, they were facing uncertain, possibly punitive restrictions on their businesses — including restrictive executive compensation and demands that they stop paying dividends and start lending.

In Canada, the aid being extended to the banking industry hasn't been nearly as extensive, nor as onerous for taxpayers. There have been no capital injections; the plan to buy MBSes is expected to make some profit for the government; and the wholesale-lending guarantee is to provide insurance at commercial rates. So, with little taxpayer money on the line, there has been virtually no similar effort to combat industry largesse. That said, the Canadian financial services industry can't expect to escape the remaking of the global industry through increased regulation, shareholder activism and increasingly stringent board oversight.

In the longer term, the question facing financial services firms, policy-makers and regulators is: how can the public's trust be restored? Indeed, many see this systemic breakdown as an opportunity for a fundamental rethinking of the global financial services system.

These institutions are under critical siege. In particular, this crisis has revealed the limitations of central banks' ability to solve the market's problems by pumping in liquidity. In fact, says professor Didier Sornette, chair of entrepreneurial risks in the Department of Management, Technology and Economics at ETH Zurich, the current financial turmoil reveals the folly of that policy.

In a paper published at the end of October, Sornette argues that this crisis represents the culmination of successive bubbles — in tech stocks, real estate and now MBSes — that were fuelled by excessively loose monetary policy designed to cushion the negative effects of the popping of each prior bubble.

The result, he suggests, is that society has been lulled into the belief that it can enjoy perpetual economic growth and ever-rising markets without experiencing meaningful contractions. And policy-makers have foolishly tried to deliver on this belief at the expense of long-term sustainability.

"What needs to be developed," Sornette's paper reads, "is a culture in which risks and downturns are understood to be the norm of nature and of society."

This time, too, liquidity initiatives alone weren't enough to halt plunging markets once confidence evaporated. Only when programs designed to restore trust among the banks were introduced did markets begin to stabilize. Sornette's paper argues that in the short term, these efforts may be "necessary evils"; but without complementary measures, "they miss the fundamental goal, which is to restore trust."

TIME FOR CONFESSIONS

Winning back the confidence of the public, the paper maintains, requires confessions from those responsible: "As humans, we are more inspired to trust when failures are acknowledged than when blame is shifted to someone else."

The issue of fairness is also essential for restoring confidence and support, Sornette argues in his paper: "This requires new strong regulations to deal with conflicts of interest, moral hazard and to enforce the basic idea of well-functioning markets in which investors who took risks to earn profits must also bear the losses."

A report by the **Network for Sustainable Financial Markets** is also calling for the restoration of the risk/reward balance. This virtual think tank was established earlier this year to advocate for the interests of long-term investors by bringing together academics and players from different parts of the financial markets in various countries (including familiar names from Canada: Ed Waitzer, former chairman of the Ontario Securities Commission; and Keith Ambachtsheer, director of the Rotman International Centre for Pension Management at the University of Toronto).

So far, the NSFM report says, investors have not been heard, as bankers have dominated efforts to solve the crisis.

The report also warns that the standard solutions to financial crises — increased liquidity and promises of added transparency — haven't worked in the long run: "The problem of wrongly sized and directed incentives, an important root cause of why we are in this mess in the first place, is not yet being addressed head on."

Indeed, the NSFM report argues, in recent years, too much financial market activity has had too little economic benefit or any wider social benefit. Too much of the risk and cost inherent in market activity is socialized, while the gain is privatized. The report argues that the balance needs to be improved so that those generating risks not only reap the rewards but also face the consequences when their bets go bad.

Moreover, the report stresses that governance and risk management need to improve, and that firms' incentives need to be better aligned with their clients' long-term interests: "Greater attention needs to be paid to how sustainable, long-term value is created, and market and regulatory reforms directed toward creating such value."

This requires capturing the true cost of industry activity and ensuring that firms pursuing long-term, sustainable growth are adequately rewarded for their efforts: "Once the immediate symptoms of the crisis have been eased, nothing less than a financial system that leads the transformation to healthy and sustainable economies should be the design remit."

The current financial crisis may be a once in a lifetime event. As such, it represents a unique opportunity to build a more efficient, sustainable financial system. **IE**