

## General Discussion: Luncheon Address

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*Mr. Bergsten:* I would like to leap for a moment beyond all the daunting immediate problems and ask a longer-run question about the work you and the FSF are doing. If I heard Chairman Bernanke correctly this morning, his discussion of macroprudential regulation included the notion of thinking over time about a common or consistent regulatory regime across different classes of financial institutions and across countries. So, I have four closely related questions for you. Would that be a good idea over the longer run? Is it a feasible idea?

If so, roughly over what time period could you imagine that happening?

Does your FSF provide the nucleus of the institutional framework that might be needed to move in that direction?

*Mr. Draghi:* Let me rephrase it in the following way. Would the FSF answer Chairman Bernanke's point about the need to have a macroprudential framework that is both coordinated across institutions and across countries? And how long is it going to take?

You've seen from what I have said today, that the line I'm proposing the FSF should take in the future is a line very much geared towards this macroprudential oversight concept. The FSF is a group of people that reflects different constituencies. It is basically a group where people who are interested in individual institution

oversight—the supervisors—meet. Then you have the Treasuries, or taxpayers' money. And then you have the central bankers. This architecture—which was designed during the post-Asian crises in the late 1990s—has proven to be very useful in addressing the present set of problems. It has proven to be quite agile and has evolved from being a place where, at the end of the 1990s, the greatest interest was in trying to understand how the Asian crisis had developed and what sort of mistakes should be avoided in the future. Gradually, most of the discussions became more concerned with regulatory issues. And now that we start seeing the effects of spillovers and the externalities of this crisis, it's naturally turning into what Chairman Bernanke defined today as macroprudential oversight.

The FSF is a group which has a well-defined constituency where the major financial centers are represented. Looking forward, we are actually planning two things. One is to see whether the membership should evolve in receiving the contributions of countries that are today still emerging countries but already big financial centers. The second thing is what sort of outreach efforts we should undertake, and there is a series of planned actions in this respect.

Your point about the need to have coordinated action is very much at the center of the FSF identity in all sorts of initiatives. Imagine a different situation. A crisis like the one we are living through naturally elicits national responses, and to the extent that these responses affect the level playing field of our globalized financial industry, this would be highly disruptive. What's happened instead is that all the regulatory discussions that have taken place since the crisis started have been fully shared and coordinated.

There is another part of the authorities' response to the crisis which we decided at the very beginning ought to remain national because there was little value added in having an international response. This is the lender-of-last-resort function, which involves the state stepping in to overcome a crisis. The experience has proved us right because we have had crises in various countries, and in each one, it took a different form from the other.

And in each one, taxpayers' money was involved so it would have been very difficult to have an internationally coordinated response in that specific field.

**Mr. Fischer:** Before transparency became a virtue, banks, especially in Europe, used to have hidden reserves and do things which regulators now don't like because they allow the banks to smooth earnings. I'm referring to the SEC regulators; the bank examiners are more inclined to see the value of large provisions. Presumably there is a social value to the banks adding to reserves and more generally to their financial resources in good times. This ends up as a tax issue, since banks are perfectly free to retain after-tax profits. Do you see any social value to giving some tax incentive in this area to reduce the procyclicality of bank operations?

**Mr. Draghi:** The question is: Should we go back to a system where banks could have higher provisions than what is now currently determined by the current accounting rule IAS 39? The answer is yes. There is a widespread conviction that the previous system—the system before this accounting provision was put into place—had higher levels of capitalization, more flexible ways of handling credit cycles.

As a matter of fact, we have a real example of a better provision, which is given by the Spanish system. Spanish banks nowadays have a capitalization level which is way higher than European average, and this is because before IAS 39 they had what we call “dynamic provisioning,” which basically amounts to what you said. The sense is that we have to do something about this, which of course is not an easy thing because of the reasons you said—because investors' interest ought to be protected. So you don't want to have situations, for instance, where the level of provisions is such that you are not actually taking care of the investors' interests. It is not an easy question to answer. I think our current system is not as good as it was in the past.

**Mr. Feldstein:** You've come back to the theme of transparency a number of times. And, it's hard to object to transparency. On the other hand, I wonder how feasible it really is. I think about the series of announcements from major financial institutions that a loss has been discovered. Do they know it in advance? Could they really

have disclosed it? Or, is it news even to the insiders themselves? Simply trying to describe the positions that they hold on their balance sheets, I think we've learned today the complexities of all of these instruments are a warning that you can't simply describe what you hold and expect anybody from the outside or even anybody on the inside to understand.

*Mr. Draghi:* I will rephrase this question as saying, Is this quest for higher transparency a realistic undertaking? Well, I can answer that: Yes, it is. It is the most important thing we can do now and the first. But the fact that firms keep on giving different figures about their losses may be due to what you suggested: opaqueness, ignorance, complexity. Or it may also be due to the fact the current economic environment is changing, therefore they simply upgrade their estimates or downgrade their estimates. But if we discuss the first possibility—as a matter of fact, especially the largest financial institutions have made a lot of progress in this regard.

Much of the ignorance about exposures came from poor risk management, because the prerequisite for managing risk across the firm, in the different lines of business, was the knowledge of what the actual exposure was. So the evidence is that risk management had been very poor, therefore their knowledge was very poor. They are updating their risk management systems now, and I would say that much progress is being made by the major firms at least. And, in so doing, they are also upgrading their knowledge.

I think this is not an effort that is going to finish anytime soon, but there is a certain convergence of interest between the regulated and the regulators in producing more transparency. However, one of the main reasons for not being transparent about certain products, especially complex ones, was that these products have a lot of property value embedded, and once you are too transparent about the complexity of these products you can really lose money.

I do not know exactly what is going to happen with respect to this dimension of transparency. For the time being, it is not the dominant one because much of the value of such complex products has gone anyway. So there is very little left to protect in this specific area. But

as I said, it is a battle that ought to be fought because it is a prerequisite for everything we have said today—for introducing these new ideas about how to improve flexibility in the use of capital, even for having monetary policy run with an eye on financial stability.

**Mr. Crockett:** Mario, we've talked a lot this morning about procyclicality. Of course, you covered it in your talk. My question is: How far does that procyclicality arise from regulatory or accounting conventions, which tends to be an assumption that people make? And, how far is it inherent essentially in the way in which the financial system works? If I think of my own institution in reaction to the events of the past year, we have raised our tier-one capital ratios substantially from what it was a year ago. That is partially because internally we feel that the uncertainties are such we need the security of a stronger balance sheet, and it's partly because the market rewards us for that. That is not because of accounting conventions, at least not directly to accounting conventions, or regulatory intervention. And, I suspect many other institutions of similar size and function as our own would feel the same. So, in addition to the question of how far is it due to the inherent nature of the financial system, to the extent it is, how can regulation or supervisory oversight deal with that?

**Mr. Draghi:** It is clear that some of our regulations do induce procyclicality, and I have said something about this before, whether it is because of the accounting system or marking to market. Here, I think we have to take something as a *fait accompli*. We are not going to change the mark-to-market system of valuation for the thousands of reasons this was found to be good to begin with. And if we start fighting this battle, the battle will be over even before we start. However, there are specific narrowly defined instances where there is a case for looking at the mark-to-market accounting. I am referring now explicitly to something that might have been hinted at in the discussion this morning: when trading is disrupted and you have to price by proxies, namely an index. An index during these periods when trades are disrupted no longer reflects the underlying value of the assets, but it does reflect things concerning risk or liquidity or other factors. Certainly you have a case for thinking seriously about that, and the IASB, having followed our recommendation, has an

expert valuation group where all the interests of the industry, regulators, and central bankers are represented. They're going to produce guidance on this specific issue. So, in my view, procyclicality is not necessarily induced by accounting. Accounting—marking to market—tells you how much assets are worth at that precise point in time if markets keep on functioning. If markets don't function, then we are in that precise circumstance. By the way, accountants tell me—I don't know whether they say this now, but they said it in the past—that people were not compelled to price using indexes. Not even before. They should price using their best judgment. Now I don't know whether this guidance comes a year too late or if it actually was there before.

**Mr. Summers:** This is somewhere between a question and a comment. I have to say when I hear the sentence there is a convergence of interests between the regulators and the regulated, I react the same way when I used to react when somebody said, "I understand the general laws of economics, but in my country it works different." There is a prospect it could be true. But you can attach a negative presumption to almost anything that follows. There is certain confusion about when you aspire to transparency what it is that we are aspiring to. Are we aspiring to transparency about the current opinion of management who have bought a set of financial assets—who, it is very clear from what has happened over the previous year, have not understood those assets very well. Is our objective to achieve transparency in respect to what they think? Or is our objective to achieve transparency with respect to some underlying reality that seems to be set or in place? I understand the sort of hedge fund world point of view, which is everything should be marked to market as close as possible where there is a good market approximation for something that is a loan book that should be used and that should be done in response to transparency. I understand that view. I understand the view of the people who think we need to interfere substantially with the normal operation of mark to market accounting because it substantially induces procyclicality. I recognize that means you are going to have less transparency, but transparency about an illusory reality doesn't have any meaning and simply operates to cause panics. I understand that point completely. The point of view that frankly

tends to come out of the official sector when it goes into conclave with the private sector—which is that we should have more transparency and at the same time be smoothing the excesses of the abuses of mark to market—strikes me as understandably in political terms that gets everyone out of the room in agreement with each other. What I actually have a lot of trouble understanding is the coherent doctrine. Can you help me?

**Mr. Draghi:** I can help you, but I have to say I was deliberately very, very circumspect about the coverage of this sentence. Let me tell you, we are in a sense at a stage which is far from the sort of dilemmas you've painted. Let me give you an example of how greater transparency can be useful and shouldn't face and has not, in fact, faced great objections by the bankers. One of the recurring questions here is comparing European and U.S. banks. What you get commonly in discussions here on this side of the Atlantic is: "We are sure that European banks haven't made enough provisions." And certainly as somebody said to me, there isn't in the United States one stone that has not been turned by now. While in Europe I'm sure nobody understands that claim. The fact that these 25 major financial institutions have accepted to respond to our quest for greater transparency, and are using the template we have given them—which is quite complete, or at least it is quite extensive—will allow us by September to know exactly the comparative state of provisioning between the two sets of banks.

This is something that some banks complained about, saying that it was very expensive, that they didn't have the management capacity to fill out this form, but basically in the end, they did it. In fact, one British bank, which has already produced its response, did a very good job. That's the sort of transparency that doesn't necessarily elicit hostility or suspicion between the regulated and the regulator. Other than that, I would agree with you. We have to start with the general presumption that the regulated entities follow a different set of interests from our own interests. There I would agree with you. I would not agree with you when you said that the two statements—agreeing with mark to market and pricing based upon indices when you have market disruption—are inconsistent. I don't think they are. I think

that when markets don't function, mark to market becomes something different. I think the IASB's interest in pursuing this line of thinking is actually quite legitimate. Having said that, don't expect a big revolution from the IASB or big changes. We'll have a millimetric response, a millimetric change there.

**Mr. Summers:** Do you accept what would be the hard-core economists and finance people's view that no financial institution should be allowed to use a pricing model which has the implication that there are obvious and easy profit opportunities by trading in freely liquid securities—that is, when, as is common in these discussions, you say, “Well, the index moves don't have anything to do with the value of our stuff because it's a crisis and it's obviously distorted and doesn't have anything to do with what stuff is worth.” A corollary of that is there is a very easy way to make money by buying the index. Most of the markets, people tend to resist arguments that have as their premise that there are a lot of thousand-dollar bills lying around on the street, and so do you accept that there is a kind of general doctrine for thinking about transparency, that yes, in some circumstances, you may need to use models and not price right along with markets? But, that there should be a systematic effort to purge the system of accounting conventions that have implicit in them the idea that there are easy profit opportunities like trading in freely liquid securities?

**Mr. Draghi:** If I could rephrase your question, Larry, I would be against any use of price modeling which would be behaving in an asymmetric fashion. In other words, if I have to change—if I have to move from mark to market—this move ought to be symmetric. Both on the downside and on the upside. And I would be against any change that would not be symmetric.

**Mr. Summers:** I understand that and I agree with you that symmetric assumptions that you can make profits on instruments that you misvalue in previous years is better than asymmetric assumptions of that kind. But, in your symmetric world you are assuming that, well, we know it's overvalued, so it can be easier to make money shorting it sometimes, and other times we know it's undervalued, so it's easier to make money being long in it. Do we want to allow accountants and managers to sort of make assumptions that imply



that there are easy profit opportunities? And isn't that the logic of a bunch of what you and others are advocating?

**Mr. Draghi:** I never looked at it that that way, quite frankly. If it is symmetric, then it means I have lost money on the way up and made money on the way down. What I am saying is that if I have a model, I have to have a consistent application of this model throughout the cycle.

**Mr. Calomiris:** I wanted to talk little bit about whether transparency is meaningful, especially during the good times; whether transparency is meaningful if banks aren't on a margin that rewards something. If you go back to the 1920s—they called it the Roaring '20s, right?—loan growth by U.S. banks was enormous, and equity ratios were hugely procyclical both because of retained earnings, stock offerings and price increases. What was different? As I think Andrew pointed out too, the regulatory environment wasn't providing so much protection for banks that they didn't have to worry about procyclical leverage. And that's the reason that the shadow financial regulatory committees of the United States, Europe, Japan, Latin America have all said that the sine qua non of reform of capital standards is to require banks to be on a debt market margin—a risky debt market margin. It is not easy to do, but it can be done. That's what real market discipline means: not just disclosing things to the market when there's no consequence. Equity markets are not enough of a discipline or reward. And you don't have to legislate transparency once you create an incentive for transparency. Banks historically found ways to communicate with markets without regulators telling them how to because they were so scared about the consequences of not communicating with the market. The big problem is banks aren't scared enough. They weren't scared enough in the boom period. Now everyone is adjusting. Now everyone is trying to get the market reward that comes from stabilizing. The problem is that happened only in the bad times. We need it to happen in good times. You're not going to get that under the current regulatory structure because the banks have lobbied to avoid discipline, as you pointed out with respect to the ratings problem. The banks lobbied to prevent this. And this gets us back to Larry's point—that we really have a political economy problem, and discipline doesn't just mean transparency.

**Mr. Draghi:** No it certainly doesn't. Much of what I said is meant to introduce discipline at good times, and so whether it will make it or not is going to be a matter of politics. Right now you have a uniform view by all the regulators across the world that once you introduce flexibility in your capital buffers that should be disciplined in such a way that banks are, I would say, compelled to pile up buffers in good times so that they can depend on them in rainy days. I think one country has succeeded in doing it. And I think it could be done. That is my perception, and of course it is a matter of perception here. It is not certainty. So far, it is a very weak statement because so far everybody is so scared, as you said, they would say yes to anything.

**Mr. Weber:** Well, last year I was quite concerned with the sort of industry leveraging process and whether we would coordinate quickly enough or provide liquidity quickly enough. I think what you said is right, if we cooperate very well with our treasuries and supervisors. This year, I am more concerned. Do we have an exit strategy? Can we make sure that the current redefinition of the regulatory framework doesn't bind us as central banks in pursuing the objectives that we should pursue? I am quite concerned that in this getting used to coordinating with all parties involved leads to a state of poor perception that this should continue into the indefinite future, and for me it is also very important what you said about the financial stability not being a concern for our primary objectives, however they are defined. Really my question is, Do you guys also discuss the exit strategy? How are we going to get out of this when the market is somewhat calmer? I think that this always needs to be kept in mind or we are lost as central banks.

**Mr. Draghi:** Again, let me rephrase your point. You are worried about too much coordination on one front, and with the function of lender of last resort. There it is clear for all central banks concerned that coordination has proved to be extremely useful. It has really played a fundamental role in the time of crisis. But none of us, well, I am speaking for people who are here, would in a sense deflect from their own mandatory, statutory objectives. So coordination is useful in the sense that it is helpful to pursue objectives that are either present in your statutory mandate or have to do with specific crisis

situations at a certain point in time. A totally different area of coordination where I don't think we should have an exit strategy is the one that pertains to both individual institution oversight, or to what Chairman Bernanke called macroprudential oversight. There, I think there is clearly value added in having coordination and in remaining coordinated. As I said before, the main value added is in preserving the level playing field of our financial services industry.

**Mr. Trichet:** From the very beginning of this interaction between the various countries concerned was the fact that after we worked out some kind of consensus amongst the "specialists," we would be able to get it done in the various countries. The Basel committee started after the crisis of sovereign debt, and then we worked it out on the basis that we would be able to get approval through normal mechanisms in the various countries concerned. We discovered it might be more complicated than that. My main question is the following. Do you believe that at the present juncture, with the pressure of the credit crisis ongoing, we can consider that this working assumption remains reasonable, and that whatever consensus we get we can move through the process and directives in Europe and the Congressional procedures in the U.S.? Are you reasonably confident that again these macroprudential recommendations that Ben mentioned will crystallize into the legal framework that is needed in most cases in our various countries?

**Mr. Draghi:** Well, another question about the realism of our recommendations, of our prescriptions, of our dreams. Let me distinguish between two issues. One is that many of the recommendations of the FSF in the report that we produced in April can actually be implemented without legislative steps. Some not, some do need that. I do not know about this country. But for the countries I can recall now, I don't see big problems in Europe with the EU commission. Actually, we have been in close touch with them since they are the ultimate legislative power in the union on financial matters. So they had better be kept on board of the work we do. So far they have been collaborative. In a sense, they should only have their enthusiasm restrained from time to time. A very different issue is the one you raised about having a sort of an internationally agreed framework for

macroprudential oversight. My view on this point is that I wouldn't know. I wouldn't know the answer. The concept is already complex by itself. I think you said so this morning, it should be defined without thinking about international coordination. But it certainly is worth fighting to have its principles—that are, I wouldn't say coordinated, but basically, shared, agreed. Whether this is going to be possible really depends on what the final framework is.

*Ms. Malmgren:* If I heard what you said correctly, and I think a message from today is as a market person it sounds like effectively through new measures regulators basically want to take the keys of the Maserati away, and get the markets with less leverage and more capital requirements to behave somewhat more sensibly and into a more sensible kind of vehicle. But, the thing is, markets still will want the Maserati, and we know from the past re-regulation experience, Sarbanes-Oxley, where we effectively deemed off-balance-sheet activities to not be material as one example. We now know how that played out. What are the chances regulators will begin to look again at what will be effectively deemed not material because that is where the markets are going to try to scheme to get the keys to the Maserati back?

*Mr. Draghi:* Again, another question which is in a sense in the same vein. What will happen when the situation becomes less strained than it is today or when the fear disappears? One answer that is more a strategic answer than a substantial one would be if we all have this worry—and we all have it—that it could be a pushback by the relevant sectors of the industry that then very little is achieved, then we shouldn't miss the opportunity to cast our intentions or policies in iron now, using the current fear as a good reason to avoid future pushbacks. I don't know whether this is possible everywhere, but certainly it is a strategy that the EU Commission is pursuing of speeding up deliberations so that some of what is being recommended in this report gets into place, into legislation soon. To say that this is possible over all constituencies—well, I would not be able to say anything like that.