



The global financial crisis: Causes impacts & policy responses

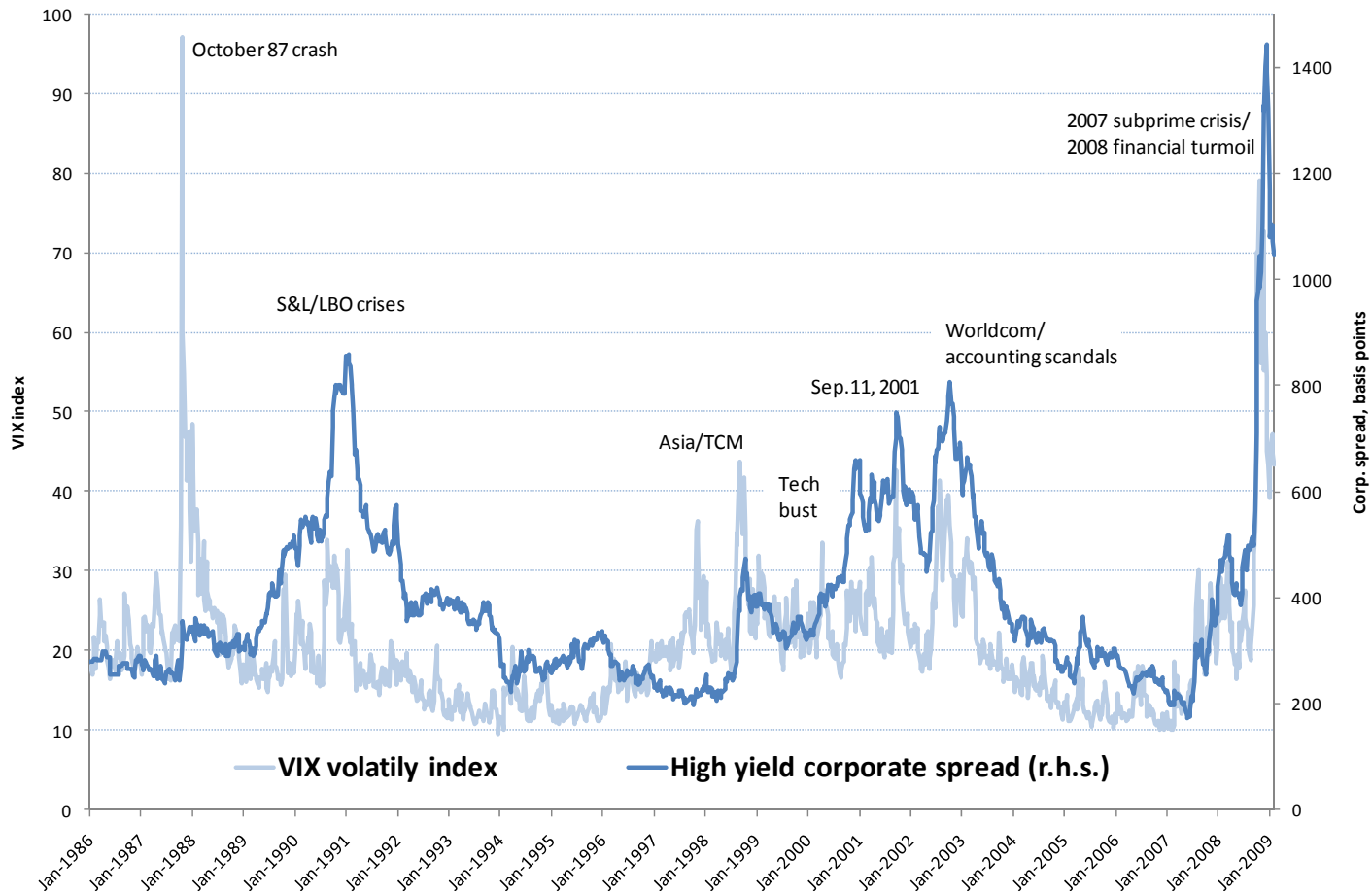
*OECD-ADB I 10TH ROUNDTABLE ON
CAPITAL MARKET REFORM IN ASIA*

ADB I, Tokyo, March 2-3, 2009

Stephen A. Lumpkin
Principal Administrator
OECD Financial Affairs Division

The views expressed in this presentation are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank Institute (ADBI), the Asian Development Bank (ADB), its Board of Directors, or the governments they represent. ADBI does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequences of their use. Terminology used may not necessarily be consistent with ADB official terms.

Episodes of financial market turmoil



Characteristics of financial crises

- All financial crises share the same core elements:
 - Some type of shock
 - Its propagation (how it spreads, incl. contagion)
 - And the broader impact
- The underlying causes:
 - Primarily microeconomic (e.g. bad banking)
 - Primarily macroeconomic (e.g. recession)
 - Primarily institutional (e.g. poor infrastructure or inadequate supervision)

Origins of the current crisis

- **The trigger:**
 - higher-than-expected defaults on US subprime mortgage loans (bad banking?)
- **The propagation channel:**
 - From real estate markets to asset-backed securities markets to bank balance sheets to inter-bank funding markets to the broader credit markets to the real economy and across borders

Exploring some important linkages

Low nominal yields induced investors to move out the credit risk spectrum

This search for yield was evident in many developments, including the increase in carry trades and growth in alternative investment vehicles such as hedge funds

It was also reflected in strong demand for new and higher risk assets such as securities backed by subprime MBS and CDOs

The strong demand for higher yielding assets supported the “originate-to-distribute” model of credit intermediation

Various entities participated in this process at various stages in the chain running from origination to final distribution

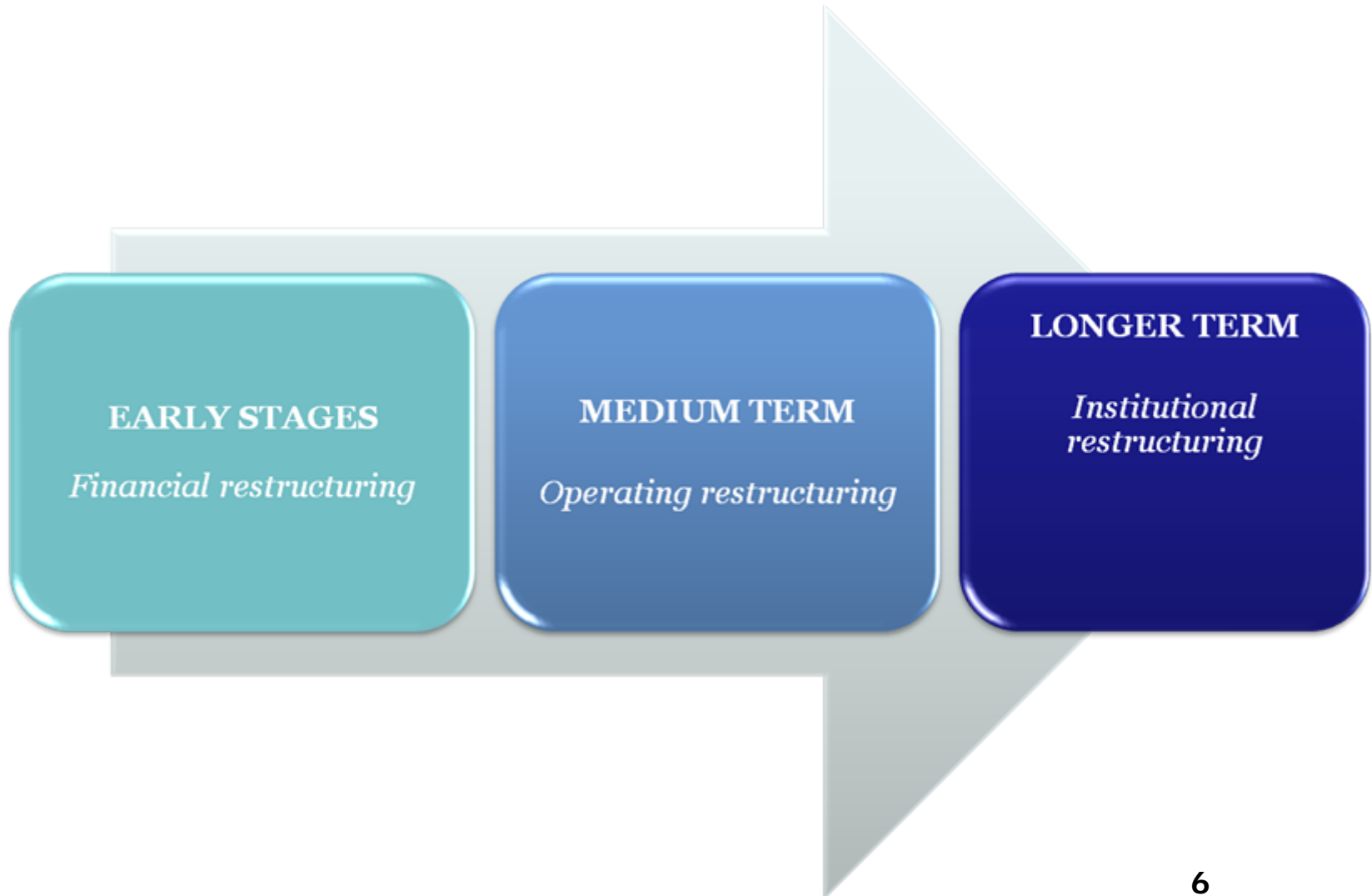
Bond insurers and credit rating agencies played major supporting roles in the disconnect between the true credit quality of the loans and the promised performance of the securities

Investors performed little if any due diligence of their own and relied solely on credit ratings they failed to understand fully

Underwriting criteria were relaxed, expanding access to credit by borrowers who were insufficiently informed or had insufficient income for the liabilities they assumed

Supervisors failed to adequately enforce proper underwriting and risk management criteria

Implications for policy



Longer term strategic measures

A critical role of policymakers is to ensure that the infrastructure of financial markets is sound:

- sound and sustainable macroeconomic policies;
- well-developed public infrastructure, including reliable accounting, auditing, and legal and judiciary systems;
- appropriate monetary controls to support sustainable aggregate economic activity and constrain major internal and external imbalances;
- sound regulation and proper enforcement

OECD's Strategic Response

Finance, competition & governance

- Incentives
- Corporate governance
- Consumer protection and education
- Regulatory quality: efficiency and effectiveness

Sustainable long- term growth

- Keeping markets open
- Macro, fiscal and labour market policies for stability & resilience
- “Green” and innovation-led recovery
- Development
- Balancing markets and policies and fostering proper exit from public ownership and other emergency measures

Good practices for an effective and efficient financial regulatory process

Regulatory and supervisory policy framework

Establish proper policy objectives

Transparency of the regulatory decision making process

Market failure analysis

Matching objectives against policy instruments

Oversight and enforcement

Assessing benefits and costs of alternative policy measures

Regulatory design and implementation

Monitoring and enforcement

Review and follow-up



THANK YOU

**Stephen A. Lumpkin, Principal Administrator
Financial Affairs Division
Directorate for Financial and Enterprise Affairs**