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LESSONS LEARNED FROM THE FINANCIAL CRISES

We have witnessed a historically deep economic recession following a crises in the global financial markets. During the financial crises we have seen a situation in which the systemic risks were clearly at hand. Systemic risks are risks on the functioning of the whole system of the financial markets, banking and monetary transfers. Crises management was successful in the fact that realisation of the systemic risk and rupture of the functioning of the banking system and monetary transfers trough financial markets was avoided. But the world was at the edge of such crises. We have also witnessed a historically deep slow down or drop in many countries of the economic growth. Governments have taken wide stimulus measures and measures to stabilise and guarantee the functioning of financial markets. Keynesian economists with Paul Krugman as the maybe the most publicity gaining representative account the avoidance of the realisation of systemic risk and even further collapse of stock exchanges and real economy as the result of the swift and wide government intervention. There is merit in this argument and it is even widely recognised by various institutions including the European Commission.

The stabilisation and stimulus measures have created liabilities and expenditure without precedent in economic history. Financial markets do function today but they are in a labile situation. There are some weak positive signals that the recovery of the real economy may start soon. The European Commission forecasted in the interim economic forecast in 14 September 2009 that a turning point is in sight even though there still is a high degree of uncertainty. Other international organisations seem to assess the situation broadly in similar terms. Situation and process in uneven in various countries and in many countries' public finances the worst is still to come. For example in the Finnish public finances the impacts of the unemployment, weak income and reduced tax revenues will hit particularly hard local government in 2010 even though there would be signs of recovery available in European national economies.

Today it is too early to draw general conclusions about the lessons learned from the financial crises and following economic recession. However, some tentative observations can be made.

Vital lesson is that a room of manoeuvre in the public finances is a very important risk management tool. Governments were able to prevent a more disastrous collapse by in-

creasing their lending and by being able to maintain trust and thus borrowing capacity. This was, however, not the case of all the governments, not even in the European Union or in the European Economic Area. Finland and other Nordic Countries, for example, gave a friendly hand to Iceland and Latvia in crises and provided lending capacity to neighbour governments in default or close to default. The capacity of governmental action requires trust to a government's own capacity to deliver its obligations. This trust shall not be taken as granted.

Partly as a result of stabilisation and stimulus and mainly for structural reasons sustainability of public finances is under serious stress. Our public finances are not sustainable. This significantly reduces our future risk management capacity. And unfortunately, there will be economic recessions and financial crises in the future.

Crises taught us also how inter-connected and related many issues considered distinct or treated in distinct procedures by distinct actors were. Micro- and macro-economics were fundamentally connected so that some of the rational sounding micro-level regulations were creating macro-economic risks. States and regions were also globally connected and problems spread from one country to another and policies in one country created negative externalities in other.

In the European Union we have a particular case of the supervision of the financial market. Financial markets are increasingly inter-connected and integrated. Banks and other financial market institutions operate very swiftly across the borders as financial conglomerates. But this is not the case of the financial supervision. Home country supervisor had, according to EU rules, the primary responsibility of supervision, but it is difficult to say which is the home country. NAOF, for example, provided expert advice to the Commerce Committee of the Parliament of Finland in a question concerning who is a Finnish Bank when we think about the financial conglomerates like Nordea, SEB operating in all Nordic and Baltic Countries. The financial supervision of Iceland was supposed to take of the supervision of the Icelandic banks in Belgium, Netherlands and Scandinavia and the Government of Iceland to stand as the lender of last resort. We still insist on national sovereignty in the areas where we have lost essential controls and decision-making possibilities giving effect to the idea of sovereignty. EU should have a more courageous and analytic discussion about the European financial markets supervision. There are existing EU agencies with much less evident reasons for existence. The de Larosière Report and the following the European Commission Communication on the European Financial Supervision with the idea of establishment of the European Systemic Risk Council and the European System of Financial Supervisors are steps to right direction but I think they are insufficient. We need to have a global system of supervision and concerning the European Union as a region and market, one could argue for a stronger step towards European Financial Supervision Authority with supra-national role and powers, like we have the European Anti-Fraud Agency OLAF.

Stabilisation and stimulus required and require international co-operation and co-ordination. It has been shown convincingly that the stimulus is more effective and efficient if it is co-ordinated among the EU countries and globally. In the case of Finland domestic stimulus has obvious limits when the problem is the lack of demand in the export sector.

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Inter-connectedness concerns also risks and risk management. Financial markets have relied on the originate and distribute business model, which lead to the growth of the items outside balance sheets of the banks. Mortgages and other loans were increasingly structured and sold to investors through special purpose vehicles. Loans were also increasingly securitised. Credit markets are, however, bound by the asymmetries of information. The original lender knows best the borrower and should have the incentives to take care of the long-term security of his claims. In practice the processes of rating and setting prize to securitised credits did not function and big losses resulted from mortgages which were rated as low-risk papers. Securitisation was apparently also used to bypass capital adequacy requirements and thereby risks were not genuinely distributed in the markets but remained de facto in the balance sheets of the financial institutions. Quality of risks and the connection of the risks to the systemic risk of the whole financial system was under-estimated. The question was of low-probability but disastrous risks and human nature tends to overlook such kinds of scenarios. The accumulation of the counter-party risks was also overlooked and thus, a significant macro-economic effect was neglected. Creation and spreading of the risks shows also connections between the regulation and risk taking. Weaknesses and loopholes in regulation contributed to the accumulation of risks.

Inter-connectedness between micro-and macro-levels are still a problem since the Basel II capital adequacy requirements and the fair value accounting are both pro-cyclical but they cannot be blamed to be the source of the crises. The pro-cyclical character of the accounting standards and capital adequacy rules deepened the losses in the event the markets were not any longer functioning properly.

In the light of the academic research and current practical experience it seems that we cannot take for granted that financial markets could always set the prizes correctly and that erroneous pricing do occur. Prize-setting errors are connected through particular feed-back mechanisms. If profits are calculated on the basis of fair value accounting and since the investors tend to follow historical information, then there is a mechanism which strengthens already existing trends and causes increased volatility in the markets. Defects in the financial accounting and management accounting information may have contributed to the emergence and spread of the financial crises.

To sum up there are connections between macro-economics and micro-economics and regulation which were not completely understood and in the future this connection must be seen in a clearer way. The proposal to strengthen macro-prudential supervision in addition to the traditional financial supervision is a step to right direction. But this is not enough. We need more forums and discussions in which the connection between macro- and micro-economics and macro-economic risks and impacts of various risks and regulation are analysed in a systematic manner.

Development of the economics of information belongs to the big scientific success stories of the 21st Century and particularly of the last 20 years. Economics of information, together with behavioural economics, is at the heart of the problems of the financial markets. The whole existence of the financial markets can be explained as an information problem and solution to the various asymmetries of information. A simple example is provided by the credit rating agencies: the lender is supposed to know best

its clients and thereby the loans. The credit rating agency is supposed to give a rating which reflects the risks. It is clear that the rating agencies failed partially to pass on this information. Also many of the risk management models failed to take into account many inter-connections which existed in the networked global economy, for example that concurrent decrease of house prices and property values in various markets was possible, and thereby these models increased already existing informational asymmetries and aggravated bad decisions. Informational problems were significantly aggravated by the fact that products had become so complex that the whole market was beyond understanding and a simple fundamental issue was hidden: there are risks, the risks should have been visible and there shall be a fair price to the risk. Transparency and clarity of the whole system and of individual risks and risk-proneness of individual products shall be increased.

Financial crises and following economic recession is also a story of the significance of governance and of the positive external effects of good governance. Incentive schemes in banks and other financial institutions favoured maximisation of short term profits. Governance arrangements should create more pressure to internalise long-term risk and risk management perspectives.

The issue of governance does not only concern individual enterprises but the whole system. We should also speak about the systemic governance. Weaknesses of the macro-prudential supervision were one issue of systemic governance beyond individual actors and institutions. We have also a problem that there are not sufficient feedback between technical and political institutions and forums and for the encounter of the macro- and micro-economic aspects and regulation. Trans-national and global character of the issues creates also a particular governance challenge: IMF says it had identified many of the dangers and risks but it lacked the possibilities and tools to address them in time. In academic literature and in presentation to central bankers these risks were recognised but ignored because they did not fit to the mainstream optimism. It is interesting to note that similar neglect of the minority view with warnings did occur in the emergence of the problem of the Mad Cow disease. Scientific warnings of the risks were neglected by main stream academic experts and regulators following them and this enable continuation of the risky and nowadays prohibited animal feeding practises in Europe. Within the European Union we also rely too heavily on the vertical distinction between Union level powers and Member States powers when many problems are inter-connected between these levels.

Accountability is a fundamental part of the good governance. We may say that regulators were not fully accountable for their action, nor were financial institutions. Accountability for cross-border issues and systemic risk management should also be strengthened. We also need improved accountability for the regulatory schemes. Accountability is also needed to over-come human greed and human laziness.

A good lesson of the crises and recession is also that fundamentals of the economy do matter. Payment capacity of the borrower is significant and for that the revenue and risks related to the security of this revenue are decisive. There will always be volatility in the markets and no-one can base in the long-term sustainable business practise to the assumption that prices will constantly increase.

One of the reasons to the crises was imbalances in global economy. Many Asian countries and economies and many export driven EU economies, Finland being a good example, had important current account surpluses whereas in the U.S. there was deficit. The surpluses were channelled to the U.S. financial markets and investors were seeking new and more promising targets. On the same time monetary policy was, if evaluated retroactively, too loose. Prices did not reflect risks. Economic growth in some economies, including Baltic States, was partly based on credit expansion. The global economy had so many anomalies and imbalances that it was mainly waiting for a trigger to set in motion a destructive search for a new balance. Global governance and accountability failed in the fact that forums to discuss and manage these imbalances were not effective.

Lesson about the economic fundamentals shall be borne in mind when we think the sustainability gap and deficits most EU Governments have today. This is also an imbalance which creates significant risks for the future.

As a result of the crises the role of the States in economy increases for a long time. This entails also risks of abuse and wrong protection of existing arrangements. Union's successes in the establishment of the internal market and the state aid rules may be increasingly under stress. We need more than ever independent watchdogs who maintain the benefits of integration and supervise the observance of the state aid rules and other common rules and principles agreed in the European Union. We need more guardians of the conditions of competitiveness.

In the light of these superficial and tentative observations of what we might learn from this crises and recession, we can observe that Supreme Audit Institutions either have a role, could have a role or have at least expertise in most of the issues I mentioned here. We as auditors certify financial, economic and performance information and thereby, though in a very different role than rating agencies, balance informational asymmetries. We create trust. We are concerned about governance and we are experts of governance. We are experts of risk management and we audit and assess the performance of authorities and action programmes.

As SAIs we do not have and I think we shall not have a front line role in the financial supervision. We have, in particular, a role as a systemic guardian, enforcer and promoter of accountability on the systemic and institutional level. We shall audit and evaluate that our overall and systemic governance structures are able to address systemic issues and risks and are able to address linkages between micro- and macro-economics. This leads to the point we shall improve our abilities to put our own observations and work in a broader perspective of systemic governance and linkages since the sector based actors lacked this broader view. We shall also, within the limits of our mandates, to have wider look to the regulation and effectiveness of regulation. Also we shall pay more attention to the inter-connectedness of the States and global level and of the States and the Union. This, together with the significance of the economic fundamentals, is a good reason why we should also work in a joint network in the audit of the EU Lisbon Strategy and European Economic Recovery Plan.

Significance of the fundamentals of economy lead to the fact that we should have a look to the effectiveness of the partnership between Member States and the European

Union institutions and this can be done only in a network of actors between Union institutions and Member States institutions. What is needed is a co-ordinated network audit in which we, following joint ideas and utilising best practises from each of us, have a look to the whole of the Lisbon strategy and to the implementation of the National Reform Programmes and report observations and recommendations on the European and national level. Substantial themes could be:

1. macroeconomic priorities and economic stability and sustainability: implementation of national reform programmes and financial sustainability of various sectors of social policy
2. microeconomic priorities: competitiveness and productivity, research and innovation
3. employment policy and the efficiency of labour market and raising the employment rate.

We have important lessons to learn and important work to be done. Europe and its citizens, our fellows and our nations expect us to deliver our share.