

**CIRANO Note, prepared by Bryan Campbell, Vice-President, Finance Group, January 2009**

During the last several years Robert Amzallag as Senior Fellow at CIRANO has taken an active interest in the research and transfer activities undertaken by the Finance Group. He has suggested initiatives that would be of topical interest to the financial industry in Montreal, particularly in derivative products and concerning practical issues in governance at the director's level. Before moving to London, he had met on a regular basis with the researchers at CIRANO. Of course, we have been eager during his career here in Montreal to listen to someone with his considerable experience in the banking sector, notably as the former President and CEO at BNP Paribas (Canada).

Mr. Amzallag is certainly well placed to offer insightful commentary on the financial crisis that has preoccupied us over the last several months, and we have taken advantage of his annual stay at his country home north of Montreal to suggest that early in the New Year he present his thoughts on the crisis. We are pleased to report in this Note that he has accepted to be the featured speaker in a Soirée CIRANO on January 9<sup>th</sup> that will be devoted to a discussion of the financial crisis.

We have also invited CIRANO Fellow Michel Magnan, Professor of Accounting at Concordia's John Molson School of Business to participate in the evening. He will present his overview of the controversy surrounding *marking to market*, an issue highlighted by Mr. Amzallag as an important aspect of the crisis. An illustration of recent CIRANO work on the valuation and management of structured products such as collateralized debt obligations [cdos] will round out the evening. Of course, such products play a star role in the events of the last year, another point underscored by Mr. Amzallag. A *Rapport Bourgogne* including all this material will be published in January 2009.

A preview is perhaps in order.

Mr. Amzallag's presentation is organized as a retrospective analysis of root causes of the crisis followed by some thoughts of what's to come. As to causes, he isolates three trends that have been gathering force over several decades. The first is the rise of risk measurement through statistical methods focusing on the determination of Value at Risk [VaR]. He argues that paradoxically the success of the methodology supported the emergence of price bubbles. The second trend is what is termed the rise of short-termism associated with the vigorous pursuit of deregulation. Coupled with globalization and the rise of the new information technologies, decision making based on market sentiment became the norm, with important institutional consequences. Finally, Mr. Amzallag points to the erosion of certain stabilizing factors, particularly in the credit market, that lead to extreme concentrations of risk. Within this framework, he charts the evolution of the crisis through the events of this past autumn.

Looking to the future, Mr. Amzallag cautiously explores the consequences of three scenarios or responses to the crisis. The first two represent the pursuit of policies reflecting established political sensibilities involving different degrees of government intervention. The third represents a more thoughtful re-appraisal of the different functions the key players—governments, central banks, regulators and financial institutions—should pursue and should be left to pursue. These are intriguing; details are forthcoming the evening of January 8<sup>th</sup>.

Professor Michel Magnan takes up the technical but crucial issue of whether fair-value accounting [FVA] was an inadvertent messenger of the financial crisis or was an actual contributor to the crisis. The point is far from academic. At a recent symposium on Operational Risk, two panel discussants—one from BMO-Harris, the other from Citibank—were very much on opposite sides of the issue. Prof. Magnan reviews recent measurement and valuation changes in financial reporting, while surveying the theoretical and empirical foundations of FVA. He then turns to an assessment of the contribution of FVA to the financial crisis via a discussion of two examples involving *Crédit Suisse* and *Lehman Brothers*.

Prof. Magnan suggests that there is some evidence that FVA is more than a messenger and may have contributed to the acceleration of the crisis. But he points to the emergence of a broader trend in financial reporting away from "accounting" to what is termed "forecounting." CIRANO intends to pursue this line of inquiry in a workshop next Spring.

**Crisis Chronology**



The Finance Group has prepared a graphic tool that permits the time-series presentation of key financial indicators against the historical background of the crisis. There are some twenty series grouped under such categories as Stock Market Indices, Credit Indices, Housing Indices, Interest Rates that can be selected by the user. The illustration above shows the Dow Jones Index, a short-term interest rate and the CDX index during the crucial September-October period. The Web site gives description and sources for the data. We also give an annotated bibliography, highlighting particularly interesting articles on the crisis.

Website: [www.cirano.qc.ca/cec](http://www.cirano.qc.ca/cec)