

Credit and Risk, in a Changing World Economy

Opening speech, Helmut Schnabel, Chairman IAFEI
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Ladies and Gentlemen

Today, this morning, we are opening this year's World Congress of IAFEI, The International Association of Financial Executives Institutes, here in Tokyo, Japan. Our international association IAFEI is in existence for 38 years. One of our best traditions is to have an annual world congress in one of our member institute countries, and we are holding it for the first time in Japan, and here in its capital Tokyo.

I am welcoming all financial executives delegates from around the world as well as from our host country Japan to this congress. In particular I am welcoming from our host country, Mr Toyoo Gyohen, President of JACFO, and Mr Katsushige Kondo, Vice President of JACFO.

IAFEI is still a growing association. IAFEI is particularly pleased, that 7 years ago the Japanese Association of Chief Financial Officers was established, that it is flourishing since, and that it has volunteered, on pretty short notice last year, to step in and to hold this year's IAFEI World Congress.

IAFEI is particularly thankful to JACFO for organizing this year's World Congress with so little lead time for preparation and organization.

Ladies and Gentlemen, in the next two days pre-eminent speakers from Japan and from around the world will make presentations on professional subjects, which are high on the agenda of the financial executives from around the world.

We are living in a fascinating world, which, permanently, is becoming bigger and smaller at the same time. It becomes bigger through trade, investment and globalization, and it becomes smaller through the information technology revolution and the internet revolution. This world keeps changing with great thrust, and is keeping the financial executives busy, alert, and permanently confronted with new challenges.

The business world in particular is in a state of permanent flux and change. Lots of good things are going on. In 2006, the world economy grew by around six percent, and in several emerging countries in Asia and Latin America it was even ten percent. In 2007, the economies of this world are expanding approximately with the same speed. While growth in North America is somewhat declining, growth in Western Europe is visibly increasing, and so it is, in recent years, in Japan as well. While at the same time in the younger economies, often called Emerging Markets, growth occurs at an undiminished speed of between seven to even eleven percent.

The USA is the only major economy in the world with a mid-cycle slowing of growth, whereas in past business cycles the mid-cycle pauses often were a global phenomenon.

Inflation is low, for several years, in the majority of countries worldwide, interest rates are low and liquidity is ample, by historic standards. All three facts are excellent prerequisites for continued good growth worldwide.

At the same time, we are experiencing economic imbalances in certain parts of the world with an unprecedented size. Famous is the current account deficit of the USA in the order of 800 Billion US-Dollars, and famous is also the ever increasing export surplus of China, but also of Japan. World foreign currency reserves are at an all time high and continue to increase, with most of them sitting in a handful of countries and country groups like China, Japan, Russia, Korea and the oil exporting countries, to just name the biggest ones.

In the long run, these imbalances must and will go away, by way of the standard economic mechanisms such as devaluations and revaluations of currencies and such as changes in national savings rates. But for the present time and the medium-term, these imbalances do persist and must be carefully managed and controlled. While great deficits are the worry of economists and financial executives, they are at the same time expression of trust and credit on behalf of the surplus countries vis a vis the deficit countries. Such trust and credit safeguards peace on a world scale basis, and it is also the basis of world trade, foreign investment and of globalization.

In the long run the free flow of information, of trade and of goods will also create freedom and human rights everywhere, but we are still not yet there, in many parts of this world, and in parts of Asia.

Again, presently, we are living in a better world than at any time before. We have trade surpluses and financial surpluses in many emerging market

countries. We have self-sustained strong growth in such countries, we are living increasingly in a multi-centre world, and the world economy is less dependent than ever of one single locomotive lead Country's well being or not well being, such as it used to be the role of the USA.

Today, when growth is slowing in the USA, as we do experience, growth does not any longer slow in the emerging markets. This is a new phenomenon.

In fact, today, the epicenter of growth is in Asia. And today, this new world epicenter of growth, is pulling upwards growth rates in the old economies as well.

We used to think in G7 or G8 terms when we were thinking and talking about the world economy. Not any longer. What we have now is a G20 or better G52 world, with good growth self-sustained in all such 52 leading countries around the world. Such 52 largest countries represent 90 percent of the world-GNP, and collectively they have a present growth of over five percent per annum.

Mainland China will become the third largest world economy this year in terms of GNP-size putting Germany into the number four position.

With Japan and with mainland China we have two of the three largest world economies in this part of Asia, where we are now. This region makes great progress in becoming the world's leading economic region, further down the road.

The weights within the world economy have changed dramatically over time. According to the OECD and the IMF the developed countries, in 1950, represented two thirds of the world economy, the developing countries only one third. In 2005, only 48 percent of the world economy is represented by the developed countries, and already 52 percent is represented by the developing countries. In 2025, it is estimated, the developing countries will then represent two thirds of the world economy.

Also, the companies and the banks in the old industrialized countries, but also in many developing countries, are economically and financially healthier now than in the 2001 world recession. The Basel II regulations will further improve the bank balance sheets and their lending standards.

Nevertheless in recent weeks the U.S. sub-prime home mortgage crisis is causing repercussions not only in the US financial market but also in the European and Asian financial markets. Who would have thought, that defaulting U.S. sub-prime home mortgage loans would be found – through the intermediary of collateralized debt obligations – in the portfolios of banks in Europe and Asia, pushing two small sized German banks to the brink of collapse.

As financial executives we are paying huge attention to this phenomenon and gladly it seems that the effects of the U.S. sub-prime mortgage crises can be contained and that they will not spread throughout the entire financial market and, more so, not to the real economy.

The repercussions of the sub-prime mortgage crisis, that we feel in other financial markets, even in the stock markets, and the money markets, are causing central banks to intervene with huge amounts of money and with

lowering of interest rates in order to maintain world liquidity, to maintain trust in market counterparts and in order to eliminate panic in the markets. Who of us has ever experienced, that banks, all of the sudden, do not trust each other any more and are not willing to make short term loans to each other?

All of this is teaching us again, that investments and performance and returns always go along with risk, and that risk is just the other side of the coin of investment and the free enterprise economy.

This crisis further teaches us, that more than ever the financial executives around this world are and have to be managers of risks.

As financial executives, you must know your risks. Yes, take your risks, yes, risks even must be taken. But take only as much as you can understand and as you can digest, and as much as you can survive. Therefore, more than ever, the role of the financial executive is to be a risk manager, and we will hear about the various facets of this part of our professional life over the next two days as well.

There has been much criticism voiced in public against the U.S.-rating agencies who have not provided an earlier warning about the upcoming U.S. sub-prime mortgage crisis. Criticism even comes from governments both in USA and Europe. This criticism and this debate about the rating agencies and their role will continue. But it must not be forgotten, that a rating is only a measure of credit worthiness and of a probability of repayment. It is not a guarantee. To use a comparison: the rating is also not a smoke detector, which is ringing alarm a few seconds before a fire is starting to break out. This is not the role of a rating.

The much more critical issue is, how – in the future – we can prevent lending practises with loose and even hazardous standards, partly to the extent of upright fraud, as we have seen in parts of the original lending practice in the U.S. sub-prime mortgage loan segment.

To put it to the point: prudence in making loans to borrowers, prudence in managing the risks that go along with making loans to borrowers, are the essence of what banking is all about. This is so, since we have a banking and a loan making industry. Or to put it differently: the best profitable lending banks are those with the lowest default rates on their outstanding loans, and this so because they know all the risks that go along with loan making and because they manage such risks prudently and effectively. For many, many centuries this is the essence of bank lending, and this is so since much, much, much longer, than since rating agencies exist, which were invented in the USA less than hundred years ago.

For many centuries, and until today, lending banks have prided themselves with knowing and practicing the lending business successfully without the support of a public rating, and they should not blame now all responsibility for their misfortunes with U.S. sub-prime mortgage investments to rating agencies, while they know at the same time, that some of them have outrightly failed in the field of their defined core competencies.

What the financial industry must also learn from the present financial crisis, is, that outright greed for profit must always be contained and downsized to a reasonable degree of endeavour for profitability. Luring profits around the next corner, as attractive as they may be, must never wash down our risk management standards.

Ladies and Gentlemen, Investment and income opportunities are huge, and so are the risks that go with them. This is the environment in which financial executives have to perform diligently. Let us look forward to the two days of this congress that will certainly help us to even better perform our job, in these fascinating and turbulent times.

I wish all of you a great and impressive IAFEI World Congress.

Thank you very much.