A window on the financial crisis - The Banker

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Published:
02 January, 2008

The issue of transparency is pivotal to the present financial crisis, writes Jacques de Larosière. He shares his thoughts on the source of the crisis and what action needs to be taken to restore investor confidence.

Markets have been surprised by the eruption of the financial crisis on August 9. But a number of analysts had drawn attention to the risks stemming from the co-existence of excessive liquidity, overextended institutions and an extreme sophistication of financial products.

This crisis is atypical. Contrary to the financial shocks of the 1980s and 1990s, the present turmoil did not come from emerging markets but from the US, the most prosperous country in the world. It originated in the mortgage subprime market (one of the most risky) and it spread worldwide, leading investors to lose confidence and to rush towards safer instruments. This process has practically dried out liquidity in a number of credit markets considered, most often wrongly, as dangerous.

How did this come about and how can it be resolved? We can try to answer this question by analysing the factors at the source of the crisis, the specific characters of this dislocation, and the actions that are needed to restore confidence and to reduce the probability of a repetition of such situations.

The source of the crisis

As has been the case in most financial crises, the present situation is the result of the combination of excess liquidity (and therefore low interest rates), an acute search for high yields (that is, for risky instruments) and very thin risk premiums, as well as an insufficient understanding of the true risks involved. The conjunction of such factors is well known in history. Usually, when bubbles have gone too far, the game of easy borrowing eventually ends at the very moment when credit defaults appear, which was the case a few months ago on the US subprime market. That is when markets realise the danger, panic and overreact.

Three issues are important for the understanding of what has happened: transparency, lower risk assessments and credit laxity, and regulation.

The transparency issue

Transparency is at the heart of the present crisis. Financial so-called ‘structured’ products are more complex (they often combine low-and-high rated assets in single instruments) and hard to understand, let alone to gauge. When liquidity evaporates, some of these assets are extremely difficult to value. Also, most of the non-banks that hold such products and refinance themselves on the market are not supervised, are not listed and therefore are not subject to mandatory disclosure rules. The amount of leverage they engage in is not precisely known in most cases. So investors who have a mandatory requirement to hold investment-grade instruments have been able to buy portions of structured products with high ratings because of bundling techniques and rating agencies methodologies. Therefore, the marketplace – when something goes wrong, as was the case with the recent increasing delinquency ratios in the US subprime market – feels uncertain about the quality of assets, and confidence starts waning. That was when contagion spread irrationally from the subprime mortgage problem into the credit markets at large and ended up in a widespread flight from risk. I cannot overemphasise the importance of transparency for preventing such systemic reactions.

Credit laxity

The fabric of ‘the new financial world’, as it has developed in the past years, has lowered risk assessments and encouraged credit laxity. The system has shifted from direct bank loans to market financing. There is nothing wrong with this evolution; it has allowed an enormous rise in capital flows and has been a major engine of world economic growth. But significant deviations – which have often gone unnoticed – have occurred:

- Global expansionary monetary policy (which led to negative ‘real’ US interest rates, in terms of expected inflation, between 2002 and 2004) has allowed liquidity to increase in such a way that the possibility of scarce money was not even a consideration in the mind of most of the market players. That is always dangerous.

- A number of financial institutions wanted to take advantage of the appetite for higher yields. They have thus systematically sought to sell their initial credits to special vehicles. In doing so, they saw two advantages: they made high fees on securitisation transactions and they got out of their balance sheets costly (capital adequacy-wise) and risky credits.

- One of the dangers of this wave of securitisation is that some banks tend to become less vigilant about the

quality of their loans and more interested in the quantity of credits to be packaged at remunerative conditions. This was particularly the case of US subprime lenders. A number of originators – some of which were non-regulated, such as mortgage brokers, and some directly regulated as investment firms or banks – were tempted to give too much weight to the growth of their business, providing they found an arranger to bundle and sell the assets as well as proper bridge refinancing. The same pattern is true for the arrangers: they only take the transitional warehousing risk and the distribution risk. They may know that the underlying risk of the assets is increasing but they do not always care because they are not supposed to hold those assets. Their reputation is nonetheless at stake.

- Spreading out risks through securitisation was seen as protecting the financial system from too much credit risk in banks' balance sheets. But, according to the International Monetary Fund's September 2007 Global Financial Stability Report (Financial market turbulence, causes, consequences and policies), "the dispersal of structured credit products has substantially increased uncertainty about the extent of the risks and where they are ultimately held", as well as about investors' behaviour in case of a market reversal.

- Perhaps the biggest danger lies in the proliferation and deterioration of special purpose vehicles (SPVs). Initially, these off-balance-sheet vehicles were not exposed to liquidity risk because they were fully covered by back-up lines granted by their 'sponsoring' financial institutions. But, more recently, sophisticated conduits in the form of structured investment vehicles (SIVs) were established with partial back-up lines. Their business was based on the premise that, in the event, their high-grade assets would not fall down the rating curve suddenly but in an orderly fashion that could be anticipated. They thought that they would be able to sell down assets and terminate hedges gradually, while still retaining high-grade debt status. All this has been severely tested by recent events.

The regulation issue

Disintermediation, as it worked in its latest excesses, performed like a huge quasi-banking machinery. A number of actors (mostly non-regulated) sold packaged credit-based instruments to investors worldwide. Indeed, the most sophisticated SPV conduits turned out to be virtual or synthetic banks, taking the same range of risks – in terms of interest rates, cost of risk and maturities. But, contrary to banks, these entities had a very weak capital base, no deposit base and were not regulated. This funding mismatch was at the heart of the turmoil. The limits of these vehicles were market acceptance to refinance them and the willingness of their bank's arrangers to set up liquidity lines.

So, the bottom line is that, besides the banks' willingness to ensure liquidity beyond the agreed back-up lines, the main constraint that applies to these vehicles is market behaviour, and market behaviour can only be guided by information and disclosure. This information was, in essence, provided by rating agencies. However, the relaxation of lending criteria for the subprime borrowers in the past two years has not been properly incorporated into the rating process. Early observable signs of increasing delinquencies came late and could not easily be interpreted in terms of expected losses.

Furthermore, rating speaks to the likelihood of default but not to the amount that may be recovered in a post-default scenario. Also, ratings cannot be considered as precise predictions of default probabilities because they are essentially linked to averages from past observations and do not grant much weight to recent trends. More generally, it appears that the riskiness of some of the individual tranches of mortgage pools has often proved to be underestimated.

If rating agencies cannot provide an adequate picture of looming potential risks, is there not a case for more preventive action through regulation, or at least disclosure? The issue cannot just be brushed aside because "markets are always right". Claiming that the market is the best regulator finds its limits when central banks must intervene to avoid a collapse of liquidity.

Taking action

Besides the subject of the subprime market – basically a serious US consumer protection problem – different issues should be dealt with. One is the issue of off-balance-sheet conduits and the reputational risks involved by sponsoring banks. Back-up lines deserve more scrutiny from the regulators. These lines were not appropriately risk-weighted under Basel I and the large exposure regime (0% risk-weighting for lines shorter than one year). The new framework is better calibrated but may still be challenged because partial liquidity lines may be insufficient and could lead to larger calls on banks. In any case, a swift and general implementation of Basel II is essential.

Risk concentration is another issue that must be addressed. Is it normal that some financial institutions have engineered SIVs with assets amounting to several times their capital? The off-balance-sheet character of these conduits seems to have encouraged some institutions to disregard the wise old rule of 'never put more than 25% of your equity on one client'. It is all the more relevant that many SIVs are concentrated in one sector (for instance, mortgage or subprime). In this case also, the reform of capital adequacy constraints partly addresses the issue (Pillar II).

The issue of rating agencies is, of course, on the list and it is directly related to the way regulation is conceived. Rating agencies have been, de facto, used too much as proxies for regulating markets while they are unable to play such a role. Furthermore, it is clear that there is an imbalance between the rating agencies' incentives to get remuneration from their clients, on the one hand, and the rather weak incentive they have to follow up the borrower's quality on the other. This leads agencies to grant limited resources to the surveillance of their ratings. Further thought on possible conflicts of interest and on the methodology used by rating agencies to assess evolving risk quality and complex instruments is called for.

The issue of transparency needs to be addressed in its various dimensions (valuation issues reporting by non-regulated entities, methodology of ratings for complex products, etc). Firms must improve their understanding and monitoring of risks (including liquidity risk) linked to credit transfer products. The need for transparency will, however, be better satisfied by the relevance of information than by its abundance. The market will only be confident when the true risks involved in such products are well understood. Some products, in particular the more complex ones, should be known as risky from the start, while others that are more simple and widespread should be constructed, marketed and publicised as largely secured (liquidity wise).

Another issue to address is whether – and, if so, how – unregulated entities, such as hedge funds, bank or non-bank-sponsored special vehicles (which have played a major role in spreading risk to investors) should be regulated and subject to capital requirements or at least be under disclosure obligations.

Lastly, given the global nature of the liquidity problems, it is even more essential than ever to try to reach, on fundamental principles, a global position among regulators and supervisors. The subject of asset management (the structure of mutual funds, maturities and exit conditions, for example) should also be borne in mind.

Boosting confidence

Most of these matters can be dealt with through improved industry practices and standards. Some matters, in my view, relate to the competence of regulators; hence, a constructive dialogue between the private and the public sector is important. This dialogue should focus on what is essential to restore investor confidence. But it should not, in any way, be construed as hampering financial innovation, which must remain alive and at the heart of our industry, albeit better explained and, if need be, better regulated.

Markets will recover even though it may take some time. We are fortunate that the fundamental factors behind world growth remain healthy, that banks are strongly capitalised and that central banks (especially the European Central Bank and the US Federal Reserve) have been wise and reactive in their interventions as lenders of last resort. We must now do all we can to restore confidence among investors while keeping in mind the need to correct

in an intelligent fashion the world imbalances that remain centred on the US and Asia.

Jacques de Larosière is chairman of the Strategic Committee of the French Treasury and advisor to BNP Paribas. He was president of the London-based European Bank for Reconstruction and Development from 1993-98, governor of the Banque de France from 1987-93 and managing director of the IMF from 1978-87.

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Financial Times Ltd, Number One Southwark Bridge, London, SE1 9HL, United Kingdom

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