The Credit Crisis Is Not Over

BY HARALD B. MALMGREN

The anatomy of a financial unravelling.

On September 18, 2007, the Federal Reserve reduced both its federal funds rate and discount rate by an unexpected fifty basis points. On the surface, the Fed got what it wanted: some temporary stability. However, the market adjustment has not been orderly—and the consequent unwinding of exposures is far from complete. On September 20, Fed Chairman Ben Bernanke told the U.S. Congress that the subprime meltdown had "triggered uncertainty about structured products more generally and reverberated in broader financial markets … The turbulence originated in concerns about subprime mortgages, but the resulting global financial losses have far exceeded the most pessimistic estimates of the credit losses on these loans … These wider losses…reflect a significant increase in investor uncertainty centered on the difficulty of evaluating the risks for a wide range of structured securities products, which can be opaque or have complex payoffs."

Recognizing that the problems are global, in September U.S. Treasury Secretary Hank Paulson encouraged the G7 finance ministers to initiate a major review of the functioning of world financial markets. He also announced that a Presidential working group, led by him, but including the Chairman of the Federal Reserve and other top regulators, would begin a review of the basic principles on which the financial system operates.

The G7 finance ministers requested the Financial Stability Forum to examine four specific issues: (1) market and credit risk practices, including treatment of complex credit products and conduits; (2) accounting and valuation proce-

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dures for financial derivative instruments; (3) basic supervisory oversight principles for regulated financial entities, especially given exposures to off-balance sheet, contingent claims; and (4) the role of credit rating agencies in evaluating structured finance products. The multilateral FSF is made up of a huge assemblage of central bankers, finance ministry officials, regulators, and financial experts from many countries. It would be surprising if such a large group would be able to find consensus about what the problems really are and what to do about them—at least in the next year. Similarly, the U.S. Presidential working group will find it difficult to reconcile the diversity of opinions among regulators with differing jurisdictional responsibilities, and among Treasury officials and those of the U.S. central bank and its regional offshoots.

It should be recognized that these international and domestic inquiries face two historic challenges: First, the regulatory and supervisory framework which had been developed over the last century or two no longer encompasses a large portion of global financial market activity. And second, they will be forced to acknowledge that the financial marketplace is no longer an agglomeration of separate national capital markets. Instead, financial innovation combined with advances in information technology has brought about a single global financial marketplace in which differences in national policies and regulatory practices provide ample opportunities for "workarounds" by innovative market participants. Among the recent lessons learned by central banks is that they have little ability to influence medium- and long-term rates of interest, that they have very limited influence on interbank lending under adverse credit conditions, and that their national monetary policies can easily be sidestepped by international operations of financial institutions. For example, when the Bank of England responded inadequately to British

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banks' liquidity needs, the British banks simply borrowed from the European Central Bank.

Serious questions also need to be addressed within the big three financial power centers: the European Central Bank, the Bank of England, and the Federal Reserve. When the euro and the European Central Bank were established, and the powers of the national central banks of the eurozone were drastically curtailed, the European Central Bank was not provided commensurate regulatory authority over eurozone banks and other financial institutions. As the powers of the national central banks atrophied, an elaborate array of arrangements were developed in the capitals of each member country in which regulatory and supervisory functions were shared between the national central banks and the finance ministries. When confronted with credit market problems and potential insolvencies this year, the European Central Bank found it necessary to carry out huge injections of liquidity to prevent a seizing up of the entire eurozone credit market. In the process, great gaps were found between the policies and practices of each eurozone member government regarding their oversight of banks and non-bank financial intermediaries. In effect, the European Central Bank had to function in a series of troikas with political officials (finance ministers) and national central bankers of each member government. The entire system has proven inadequate during the current credit market turmoil.

Looking forward, it is evident that the real estate bubble is bursting in Spain and around the Mediterranean, as well as in parts of Eastern Europe, with uncertain consequences for eurozone financial institutions which have adopted many of the financial innovations in securitized debt obligations and credit derivatives—as well as innovative reliance on carry trade funding. The foundations of the eurozone banking system and credit market will continue to be stressed by a combination of the deflation of the real estate bubble, continuing global credit market turmoil, and a slowdown in global economic growth.

In the United Kingdom, it has similarly become apparent that the elaborate tripartite bank oversight system which had been created in 1997 by then-Chancellor of the Exchequer Gordon Brown no longer functioned well in 2007. The 1997 changes had included independence for the Bank of England, transfer of regulatory and supervisory functions to a separate Financial Services Authority, and lender-of-last-resort functions remaining with the Treasury. When British bank Northern Rock faced a bank run, no conventional rescue operation was available. Improvisation was necessitated by the fear that the simultaneous stresses of a run on Northern Rock and the apparent seizing-up of the short-term credit market could endanger a wide variety of UK financial institutions. The press and some politicians were quick to blame Bank of England Governor Mervyn King for obstinately refusing to provide liquidity out of aversion to rewarding imprudent bankers. However, the problems of the UK financial market also stemmed from the ineffectiveness of the troika system itself, with the Financial Services Authority sleeping through the deterioration of credit management within the banking system, and the Treasury late to recognize the need for action to avert a broader crisis. Moreover, the press focused almost exclusively on Northern Rock, without looking at signs of exposure among other UK banks in their elaborate utilization of off-balance sheet conduits which in turn relied upon short-term funding.

Looking forward, it is now likely that the UK economy will face a serious negative correction as a result of the turmoil in the UK financial market. Large-scale redundancies are expected to be announced in many financial institutions and hedge funds, and year-end bonuses are expected to be abolished or minimalized. The London real estate market is already in the early stage of a serious downturn. It is often estimated that some 40 percent of London area employment is dependent on the financial services sector. To the extent that banking activities are put under improved supervision, with greater transparency, this will likely result in some degree of credit contraction. Markets have already sensed a turning point as the British currency has come under negative pressure.

The U.S. financial sector has long functioned under an elaborate regulatory system involving the Federal

Reserve, the Treasury, and a variety of other national and state regulators. The recent credit market turmoil is revealing large inadequacies in the present regulatory system. The complex, shared responsibility system of decades past simply does not address what is taking place in today's financial market. Large banks now operate globally. They rely on fund management, trading, and the "originate to distribute" model to provide a major share of their earnings, essentially operating as non-bank financial intermediaries. Hedge funds compete with banks to provide funding for complex mergers and acquisitions deals and other large-scale loans. Depositors are no longer the foundation of banking. Now, the primary suppliers of capital are public and private pension funds, insurance companies, foundations, endowments, and other sources of passive investment.

In the credit market turmoil of recent months, the trustworthiness of the non-bank financial intermediaries has been damaged. The breakdown in marketability of many assets and the perception that "toxic waste" has been spread widely throughout the financial market has generated widespread distrust. At the start of October, the true exposure of many large-cap financial enterprises is not transparent. Worse, it is not even well understood within management of these enterprises. Many of the large-cap financial institutions are now doing internal audits and forensic analyses to determine the scope and depth of exposure. As these internal inquiries proceed, more questions emerge. The markets are clamoring for "transparency" but it may be inordinately difficult to provide true transparency after so much mathematical mixing of risks and securitized debt has taken place. In addition, the question of elaborate utilization of off-balance sheet conduits will have to be faced: if these conduits need to be included in capital ratio requirements or in some other way fortified, the result will be credit contraction.

It is highly unlikely that in the short time remaining for the Bush Administration it will be possible to establish appropriate fundamental reforms of the present U.S. credit markets. Even if some important improvements could be suggested, Congressional action would be hard to achieve in the time remaining before next year's national elections.

In the words of Fed Governor Frederic Mishkin, "our increasingly globalized and sophisticated markets are still vulnerable to systemic risk." The markets will continue to be challenged by uncertainty about the extent of risks and where the risks are ultimately held. Mishkin also points out that emerging markets are particularly vulnerable to systemic risk, because they have weaker institutions, less-developed financial markets, and an absence of easily available information. Their central banks cannot be expected to function as lenders of last resort. As we have observed in the past, risk spreads on emerging market debt have still not widened to the levels of historic averages—which means yet another financial market vulnerability in the future.

In response to this summer's crises, Deutsche Bank CEO Josef Ackermann urged that all big financial institutions should embrace transparency. ECB President Jean-Claude Trichet said on September 29 that "In hectic times, when fear dominates, the absence of transparency fosters herd behavior and amplifies considerably the initial shock that triggered the turbulences…Transparency *vis-à-vis* investors and savers, transparency *vis-à-vis* surveillance authorities, appears to be the best vaccine against contagion." Financial markets may move in that direction, but full transparency would require revealing exposure to risky assets and major changes in how financial institutions operate. Full transparency would entail major changes in the trading activities which supply the primary source of their earnings these days. Increased transparency would likely bring many benefits to markets, but also many new challenges to how markets operate. ◆

Not Your Father's Financial Market

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