Global Financial Market Turbulence – Causes and Consequences

René Karsenti is Executive President of the International Capital Market Association (ICMA)

We have heard much in the last few months about the causes of credit, liquidity and risk management turmoil. It is as yet still too early to draw definitive conclusions about either the causes or consequences of recent global financial market turbulence, however the following are some reflections on recent events from the perspective of an international self-regulatory financial market organisation. 1

We are now in a period of what I would consider to be a long overdue reassessment and repricing of risk, after immediate and intensive corrective actions to preserve liquidity in financial markets. The market turbulence of this summer illustrates also the consequences of a period of over consumption and over production of complex financial products which was combined with serious difficulties in monitoring the associated risks. Indeed the benefits which should normally have been derived from financial innovation such as complex securitised products have in fact been associated with a new configuration of risks. We have observed over the years the eagerness of certain financial intermediaries to shift to the “originate and distribute” model, while weakening their due diligence process and an immense investor appetite to increase returns by assuming complex risks that were not always fully understood. The situation was compounded by the outsourcing of important internal due diligence responsibilities to credit rating agencies and other third parties. At the same time the use of such new complex instruments was not supported by sufficiently adequate and comprehensive risk monitoring functions; it also involved a global distribution which included investors located in jurisdictions lacking sophisticated oversight.

Inevitably, the market has become much more cautious. Risk is being repriced and the market has yet to recover. This also has an impact on the quantity of new issues, with less supply as M&A and private equity activity has decreased; and less demand as hedge funds become less active. And there will also be an impact on quality, as arranging banks become much more conservative in their assessment of creditworthiness, and issues with weaker covenants become more difficult to sell to investors.

Nevertheless, despite this serious turbulence during the summer, we should take some comfort in the fact that a resilient financial infrastructure exists in our markets, in particular in the area of clearing and settlement which has continued to operate without any failure.

Undoubtedly, the turmoil in financial markets will affect real growth in the international economy, but it is much too early to say how large the downside will be. That depends on whether the turbulence is limited to a (healthy) short-term market correction or the start of a prolonged downturn. I do not believe that anyone yet knows this for certain. But clearly such turbulence has highlighted, I believe, the need to enhance substantially practices in the following areas: prudential supervision; risk management; transparency and due diligence processes for structured products; the role and methodology of rating agencies; valuation of complex instruments and the need for enhanced best practices.

Role of central banks

The central banks were right to intervene from August 9 onwards by pumping liquidity into the system, not just overnight but for up to three months, and in some cases by expanding the range of collateral they accepted in exchange. Initially, some commercial banks hoarded liquidity (eg by investing in Treasury bills), but in time they extended sufficient liquidity to the wider market. Central bank intervention does seem to have had an effect in steadying the market; and commercial and investment banks have also helped to calm the market by giving a lead for reputational – rather than purely financial – reasons: eg by deliberately drawing on Fed funds when they did not need to do so.

Central banks do have the opportunity to influence the outcome by reducing interest rates if necessary, as the Fed did on September 18. A separate question, when they set interest rates, is whether central banks should in future target asset prices as well as CPI measures of inflation. In general, when they set interest rates, central banks already take account of the impact of asset prices on inflation. But it is difficult to hit two different targets simultaneously.

Central banks were clearly right to inject liquidity into the market in response to financial market turbulence. The difficulty they face now is how to maintain confidence in the system as a whole without giving the impression that they will always bail out individual institutions, and so encourage imprudent risk-taking in future – moral hazard.

The turbulence in financial markets has presented a classic case for central bank intervention on financial stability grounds. But the difficulty in this case has been that, with limited exceptions such as the classic bank run on Northern Rock in the UK in September, the problems have emerged initially outside the traditional banking sector.

Regulation

The financial crisis has also raised the related question about where the dividing line should be drawn between financial institutions that pose potential risks for the financial system as a whole, on the one hand, and financial institutions that central banks can allow to become insolvent without posing such risks, on the other. And if certain non-bank financial institutions pose systemic risks, should they continue to be supervised more lightly than banks?

In Europe it is not clear whether Basel II and the Markets in Financial Instruments Directive (MiFID), if they had come into effect earlier, would have made a significant difference either in preventing financial market turbulence or in resolving the problems that have emerged, although risk and conflicts of interest management would have been subject to greater self analysis by financial institutions and enhanced regulator oversight in some jurisdictions.

One particular problem is that the treatment of collateral under Basel II may need to be rethought. The question is whether Basel II gives excessively generous terms to collateralised instruments and covered bonds (eg in relation to unsecured interbank lines). And if the authorities need to rethink elements of Basel II in relation to the banking sector, this may also have implications for Solvency II in the insurance sector.

But the G7 has now set an agenda via the Financial Stability Forum covering liquidity and risk management, accounting and valuation of financial derivatives, role, methodologies and use of credit rating agencies, and principles of prudential oversight including the treatment of off-balance sheet principles. To which I would only add the issue of due diligence by buy-side institutions.

We will see what emerges in due course and will seek to contribute constructively to the outcome in the interests of promoting an efficient and stable market environment in the interest of all constituencies. However it cannot be in anyone’s best interests to rush into a ‘knee jerk’ reaction to these events resulting in unnecessary regulation which could stifle future innovation and development in the capital market. None of us wish to see ‘unintended consequences’ as result of hastily drafted regulation, which could result in financial transactions becoming more risky. Diagnose before prescribing!

As an organisation representing a broad range of capital market constituencies with a European focus, ICMA’s objective remains to ensure the continued smooth functioning of the markets within the context of a resilient and stable infrastructure while limiting unnecessary regulation which could restrict innovation and efficiency in the future.

As a self-regulatory organisation we believe in the value of industry-led solutions to market issues and continue to stress the importance of dialogue with regulators and a measured approach.

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1. Based on the speech given to the EURO50 Group, Washington, October 21, 2007