



Financial Market Turbulance

Adrian Blundell-Wignall, Deputy Director, Financial and Enterprise Affairs, OECD

Financial Turmoil

The Turmoil

My comments are my own, and don't purport to represent an official OECD view.

We are only at the beginning of the economic consequences of the bursting of the subprime bubble. We have a banking system desperately short of capital—both in the USA and here in Europe, where people seem (wrongly in my view) to be very sanguine about the likely fallout.

In essence, banks are very highly leveraged institutions. They borrow money from depositors and the wholesale market, and they lend it to firms and households who want to spend on housing, investment and consumption. Sitting between these 2 vast balance sheet concepts is a thin sliver of equity, or capital—and it does not take much (particularly with mark-to-market accounting rules) to wipe that capital out when loans default or securities fall in value. Losses related to subprime mortgages in off balance sheet vehicles came back onto the balance sheet and destroyed capital.

The subprime crisis is a householder solvency crisis in the underlying mortgages, which is being exacerbated by security structures, mark-to market accounting rules and liquidity problems. The capital write-offs caused by these losses can bring about very powerful effects on economies through credit crunch mechanisms—or, more technically, what we call deleveraging.

When a bank loses that thin sliver of capital, or goes below the regulatory minimum, it has 3 basic choices:

1. To raise capital, by diluting the shareholders with new equity issuance or subordinated debt.
2. To retain earnings and cut the dividend, so that capital is built internally—but this takes more time. OR
3. Cut back on lending and reduce its balance sheet, so that the smaller capital base is consistent with capital requirements. This latter route gives rise to the credit crunch. If banks don't lend and call in loans, you will have a recession—exactly what happened in the 1991 crisis.

Last year we at the OECD were the first to put out a big estimate of the likely losses--\$300bn we said. It can't be all the competitor organisations said—alarmist OECD! Now of course some are scurrying past us. Our latest number is around \$400billion, a bit up on last year, but not too far. A \$400 billion loss is very bad because those thin slivers of capital are so 'thin'. Of this, about \$90 billion will accrue as ultimate losses to the US banks (about \$130 billion is in Europe, and \$180bn is split between non-bank US investors (insurance, hedge funds and fund managers). This \$90bn of losses will be difficult to raise as new capital—they are more than half way there—but initial SWF investors were so burned they won't be back for a while. More importantly, \$90bn is not enough—covering the only the losses lets you have a flat balance sheet—that's what happened in 1991—it still gives a credit crunch, as the economy needs to grow. To grow by the average balance sheet growth of 7% pa would need more than double this amount of capital to be raised. If you do it by earnings, and no lending, we think it will take 5 quarters for the crisis to pass—taking us through all of this year. So there is plenty of time for a credit crunch and economic problems—with the risk of flow-on effects to other sectors like corporate bonds, equities and hedge funds, as a recession unfolds.

This is the 3rd major banking system crisis since the early 1990s, and maybe the biggest. The risk of a credit crunch is large. Europe is lagging behind the US, but similar forces are in play. In the case of Bear Stearns, taxpayer's money has been used to guarantee the Bear Stearns portfolio beyond a certain amount of loss—and it can by no means be assumed that this is the end of it for Bear Stearns and anywhere else. I think few people realise, that had the FED-JPM weekend rescue not happened, then during the following week at least 2 more investment banks were at grave risk: that is financial meltdown territory. At this point there was no choice—but how did we get to this position that we should never have been in? Taxpayers' money should not, in principle, be used in this way.

Now we have to ask: can the effectiveness of markets as an allocator of capital amongst competing ends be relied upon in the future, when the trade-off between risk and return is now so asymmetric, and banks know they are too big to fail. As the memory of this current crisis fades, we will be straight back into a process that leads to the next one.

It is like the space traveller about to pass into a black hole, asking a Martian the way back to Earth—he replies, if you want to get to Earth, you shouldn't be starting from here. But we are starting from here. There needs to be some new thinking about reform of the regulatory and policy making paradigm for the longer run. I will come back to this point at the end.

Sudden Explosion in Private Mortgage Securities

In a nutshell, the genesis of the crisis was a rapid—no, a parabolic—acceleration of private-label securitised mortgage products, sold into off-balance sheet entities, like SIVs and CDOs. From 1984 to the middle of 2004 this industry had grown respectably to about \$820bn outstanding. From mid 2004 to the end of 2007—only 3-1/2 years—this amount exploded to \$2.1 trillion. That is 160% expansion in a compressed period over

the amount it took 20 years to accumulate! It is a real puzzle as to why this happened; and it is also very interesting as to what had to be stretched to enable it to happen.

Causal Thinking and Policy

If we want to get this right for the longer run we need more causal thinking. Causality is about exogeneity, and usually comes from distortions frequently related to policy. Other factors are conditioning in nature, either helping to restrain or to exacerbate the distortion.

One clear causal distortion needing an outlet was the global liquidity rapid expansion caused by Chinese and other fixed exchange rates, leading to intervention and loose money that is recycled back into markets. The Japan 0 rate policy is also a factor here, as was the Fed 1% interest rate policy. This global liquidity bubble, and the search for yield to which it gave rise, like excess water, had to flow somewhere. But what was the trigger that made that “somewhere” US private label mortgage securities from the end of 2004?

Let's play “Cleudo”—I think they call the game “Clue” in the USA. You know that childhood board game—how was Dr Black killed—by Scarlett, with the dagger, in the study. I'm sure you know it.

1. So, was it a sudden move to Fed 1% interest rates in 2005—no this happened 3 years before!
2. Was it that securitisation was discovered in 2005? No, securitisation had been around for at least 20 years.
3. Was it the discovery of levered vehicles like SIVs and CDOs in 2005 and the originate-to-distribute business model itself? No, these had been around for 10 years.
4. Was it poor lending standards that caused it? It is hard to see why lenders all woke up in 2005 and said: ‘today we will relax our lending standards’. This was one of the things that had to be stretched to make it happen, but not the cause.
5. Was it the Credit Rating Agencies? Did they suddenly they decide to deteriorate their models and do a worse job from 2005. Or was this another stretch factor needed to make it happen?
6. Was it poor corporate governance and poor risk control? This is getting a bit a little ‘warmer’ as to who killed Dr Black, because there were some banks that did not play, or played less, in the subprime market and did not end up dead in the study. But for those who did end up in a bad situation, it is still hard to think of it as causal, as opposed to a factor that could have helped stop it. Boards don't deliberately try to kill the bank—they make mistakes, motivated by profit motives as they negotiate poor regulatory frameworks—but they are not murderers.

The main thing a bank does when it makes a loan is to generate private information. They find out all about Adrian, his income and wealth, and they make a loan to Adrian and they go on monitoring him over the course of the loan. With securitisation they don't have to do this. But banks' selling their loans off to the capital markets by securitisation is

a rather curious phenomenon. It is the old lemons problem—why do you want to sell me this used car if it is so good? What's wrong with it? We know how banks did this: they got good credit ratings from the Credit Rating Agencies, they used the bond insurers, and they created their own leveraged demands for the loans they originated via the infamous conduits, lending standards dropped as the risk was apparently transferred, and so on. We also know that corporate governance and risk control let it pass in many cases. But what caused them to do it so suddenly from the end of 2004?

The Basel 1 system encouraged regulatory arbitrage, and never provided a capital constraint on banks. Banks were told in June 2004, that this would get even better. For the big banks involved in the crisis, they were told that by 2008 they would move to a much more complex system—the 'revised framework'—or Basel II, where they could pretty much set their own capital in the so-called Pillar 1, using their own internal risk modelling—and this modelling was showing a big drop in the risk weight to mortgages.

From a regulatory paradigm point of view—pushed by the banks themselves—this is like saying the poachers should become game keepers, counterbalanced by supervisory oversight in Pillar 2, to be sure, and better by disclosure in Pillar 3 (to help market discipline). But the key moving part—is the Pillar 1 capital requirements. To get an insight into the internal workings of banks in this respect—who would be entrusted with this crucial role—just read the UBS report to shareholders post the crisis, forced on them by the Swiss regulator. With internal competition over resources and the struggle to dominate the bonus pool, the risk is that ways can be found around internal and external risk controls in enough institutions to cause systemic problems. The more complex the system, the more scope there will be!

Basel II envisages credit conversion factors for off-balance sheet exposures, so if conduits were to be taken advantage of in 2005 the water would need to flow to the lower risk (reduced capital weight) mortgage area, and the added complexity of the system left plenty of scope for the 'art' of accounting to manage if need be. But on its' own this was not enough. This new information in 2004 still needed something more. It was perhaps a necessary but not sufficient condition for the parabolic rise of RMBS.

The sufficient condition, with this background, came with one of the US regulators imposing a contraction and then a level constraint on the balance sheets of government-sponsored Fannie Mae and Freddie Mac. Now a big part of bank revenue comes from selling mortgages to these government-calling-card monoliths that dominate the mortgage securitisation process in the USA. At the strategy level the revenue gaps had to be made up. With the walls of the Fannie-Freddie fortress down, banks could move in to what they had always thought should have been theirs in the first place. Private label Fannies and Freddie's could proliferate, and revenue gaps opened up for those who were slow to participate. Think of a big patchwork balloon. If you impose inflexible strips into it, then the hot air just forces its way into the flexible parts. At the micro level, bonus remuneration and the profit motive sets in train incentives to hit the new growth areas hard, and the flexible parts (like credit ratings, lending standards, corporate governance, risk control, etc.) began to stretch.

My time is up. But I do want to finish on policy. What do we make of this tour d'horizon?

1. Regulators following narrow entity institutions and working without a macro overview of the whole financial system is a problem. So think about the Australian tri-partite model. (1) The central bank looks after the lender-of-last-resort and the stability of the financial system; (2) ASIC is consumer protection and market integrity regulator; and (3) APRA is the mega regulator of prudential standards across all financial institutions. Regulatory competition and confusion is thereby avoided.
2. For capital regulation—please—keep the poachers out of the woods with their game warden hats on. Simplicity that prevents regulatory arbitrage is the key! Complex systems that are inherently 'pro-cyclical' and rely on private sector modelling are problematic. Probabilities of default, external ratings do move up and down with the trade cycle so capital regulation is pro-cyclical under Basel II, while complexity lends increased scope for regulatory arbitrage.
3. Let's do all the other things too—improve governance, get the right structure in the Credit Rating Agencies and Audit firms, and improve standards for lending practices and the treatment of off-balance-sheet conduits. But without fundamental reform on the structure and functioning of regulation, this still risks tinkering at the edges. The distortions from fixed exchange rates in some regions need to be included in discussions, alongside proposals to remove regulatory distortions.