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Financial crisis - Why do we have it?

The Start of the Crisis

The underlying problem has been easy credit for many years.

Full analysis of this is complex, but there is no doubt that increased standards of living and home ownership for the less well-off portion of society have resulted from innovation in lending practices.

However it escalated too far with practices in many areas of the financial sector falling short of what it should have been. This includes substantial failures in supervision as well as in the financial institutions themselves.

The US Contribution: Sub-Prime Mortgages

The 'last straw' that triggered the turmoil was a large number of dodgy (sub-prime) mortgages in the US.

These dodgy mortgages were being given to those who could not afford to repay them and without any deposit element. Loans that are backed by a charge (such as on a property, known generically as collateral) are an asset because they provide an income from the repayments. There is also the underlying value of the property in the event of default. So loans can be held as an asset or sold on to others. It had become an encouraged banking practice to sell the loans on by packaging them up with other mortgages (safety in numbers) and selling the package in slices, some being very good slices and some not so good (so-called securitisation). Sometimes this pool and slice process was repeated so the product became very complex.

Purchasers of the securitised loan products knew the type of slices they were getting by taking note of the ratings (done by Credit Rating Agencies). However, as the purchasers were other financial institutions they should also have done their own research or 'due diligence' on the nature and safety of the asset they were purchasing. Likewise supervisors of financial institutions are supposed to understand the assets of the institutions that they regulate.

It then became apparent that the real bottom end borrowers had a different attitude to their mortgage than had historically been the case. Instead of doing everything to hang on to their property by paying their mortgage, they walked away and defaulted because they had no equity to lose.

This put more property on to the market and house prices fell (a slow down in house prices in the first place also helped to trigger the chain reaction). Remortgaging using the increase in value in property to pay off mounting debt ceased to be possible and a vicious circle went round and round.

The higher rate of default than had been expected in the rating agency models led the rating agencies to lower the ratings on the slices of loans (the so called collateralised debt obligations CDOs or more accurately a subdivision of them called Retail Mortgage Backed Securities,

RMBSs, now more generally called toxic assets). There was criticism that the Rating Agencies were too slow to downgrade, but the real mistake they made was basing all their modelling on historic US housing trends. Thus they assumed for example that different regions in the US would not all see a fall in prices at the same time.

The Banks

Reducing the ratings of the 'securitised loan assets' made them worth a lot less, and where they had been used for further security, there was now fear of default.

Such was the level of complexity of some of the packages that had been through the pool and slice process more than once, and it has to be said sheer lack of due diligence by purchasers, that nobody seemed to know where the bad stuff was and everyone became frightened of doing business with other banks in case any of the collateral they offered was contaminated. This was further exaggerated because the 'monoline' insurance companies that specialised in giving insurance to these kinds of products became overwhelmed by the volume of default and so sufficient insurance was no longer there (one of the reasons for AIG going under eventually). Other ways of the banks raising money (the money markets see below) also dried up. This was the start of the credit crunch at the inter-bank level.

Although the level of defaults went up, it was by a few percent so the assets were not valueless, but they were uncertain. However for those who needed to be able to use them for trading or collateral they were effectively without value. Under accounting rules, assets have to be valued at a market price (mark to market) so now a lot of assets became valued at almost nothing, so this triggered a lot of write offs on bank balance sheets, leaving them with inadequate capital reserves.

So they had to raise funds and grab everything they could and part of that was stopping lending to ordinary businesses and individuals. This was the start of the credit crunch for the rest of the economy.

Everything Gets Worse

Money Markets

In ordinary times big investors with spare money (including banks) put it on money markets where it can be borrowed by financial institutions.

Now it was no longer seen as safe because those borrowing it might not have the right assets to back up their borrowing. So people took their money away from the money markets.

This meant that organisations like Northern Rock could no longer get enough funding and coupled with the underlying 'bubble' in the UK housing market they were among the first to get into trouble.

Central banks made more money available (liquidity) for borrowing by banks in order to try and start things moving again. They also accepted a much wider range of security from the banks including some of the dodgy stuff.

Unfortunately it did not make banks start lending to one another again nor release money for business because they were all shoring up their capital reserves.

Lehman fails

Everything got very much worse when Lehman was allowed to fail.

Interestingly one of the reasons it could not be rescued was because Governments would not put enough money in and over the final weekend it seemed that (again) various transparency or

consultation regulations prevented pre-emptive rescue. Probably the massive rescues subsequently mounted would have been needed without Lehman's collapse, but it precipitated the situation. Unwinding Lehman will take years and has created other knock on damage, so it has made a bad situation worse.

Rescue Plans

The original US rescue plan was to buy up a large amount of the dodgy assets.

This wasn't entirely silly because if they are kept for long enough they will revert to having a substantial value because most mortgages still do not default. This is just as well since, especially in Europe, a lot of the loans are sitting in pension funds, especially in Europe.

The UK, and now the US and much of the rest of the world has other elements in the rescue package. Most notable are putting capital into banks by buying some form of share and guaranteeing the inter-bank loans so that banks will return to lending to businesses. (Not all of this works smoothly cross-border because countries only want to guarantee within their own borders, because that is where the taxpayers are.)

A return on the money invested is taken right from the start. The UK demands a 12% 'coupon' (interest payment) on its preferential shares. (There is some concern that this is too high, other countries have demanded less. On the other hand it gives incentive for the preference shares to be bought back.)

Restraint of fat cat bonuses is being attempted on an international basis, so stands more chance of success. The reason this is so is because if one country alone restrains executive pay, then the executive talent will happily migrate to less stringent jurisdictions. The UK is not yet delivering enough on bonus restraint and it will need more than just the FSA making pronouncements.

What's next?

There will continue to be knock-on effects into the economy because even if lending returns to more normal conditions, it will not be on the same easy to get basis as before.

For example, the huge finance package that the US has given its car industry is because they would otherwise have gone bankrupt simply because adequate refinancing packages could not be structured anymore. Lowering interest rates will be used to try to offset that problem.

Share prices will continue to fall for a variety of reasons - fear of recession, knowledge of refinancing problems and some institutions having to sell to make payouts. There are lots of calls for more regulation. However rather than a lack of regulations, the failure has been rather more down to the failure of governments to apply existing regulation properly at the national level (poor supervision or lack of supervisory capacity) and a lack of joined up supervision between countries.

What we have to do now.

Much of the action to combat the financial crisis must take place at the European level.

In the wake of the financial crisis, a number of projects that have been ongoing for some time now take on greater importance.

As a member of the European Parliament's Economic and Monetary Affairs committee, these projects have been in my in-tray for some months, and for a number of them I have been lead rapporteur.

Capital Requirements Directive

Revision of the banking directives was already planned and this has been additionally modified to address matters such as complex securitised products and some supervisory changes, such as colleges of supervisors for the largest cross border groups (which was planned anyway before the crisis). Accounting rules (IFRS) have also been changed to allow some different treatment of assets without a market.

Credit Rating Agencies

A registration process and oversight of Credit Rating Agencies will come out in November. This may be tricky to get right because ratings are international. Greater transparency of assumptions and various other things are expected. There are also useful US moves to establish a profession and qualifications for analysts.

Derivatives

It has long been wished to know more about the derivatives that are sold over-the-counter (OTCs). These are tailor-made deals or options to suit particular circumstances, for example for a specific period that suits the needs of the purchaser, possibly for insurance or hedging purposes.

Moves to enable OTCs to be cleared on exchanges (so that there is more knowledge of what is out there) have been under development for some time with the advent of better technology to cope with complexity. There have been fears that clearing would add to cost and if undertaken unilaterally would just cause the business to move elsewhere. Coincidentally this is all coming together now and regulation to maximise its uptake is likely to be forthcoming. There has been an announcement by the Commission of a communication by the end of the year.

Solvency II

This is the revision of the insurance directives that has been going on since summer 2007 and has attracted extra amendment in the light of circumstances as well.

Proposals for changes in supervision, in particular colleges of supervisors, group supervision, and the role of the EU supervisory committees, were always reckoned to point the way for some corresponding changes in banking, again showing that work in this direction was underway before the crisis.

There is still a lot of trouble in getting agreement in Council on how the cooperation should work. There has been blood on the floor in Parliament too. Members have not been as European-minded in legislation as they have when voting reports(!), and unfortunately most have reverted to their Member State positions.

Lamfalussy

The review of the special 'Lamfalussy' procedure that is used for financial services was also under review.

The significant part of this is the so-called 'level 3' committees which are composed of the regulators of each country. (There are banking, securities and insurance committees because regulation is separate in many countries.) The level 3 committees have a role in preparing implementing regulations and advising the Commission on detail of legislation, and seem to have a much more involved role than 'bodies of regulators' in other fields, but do not have agency status and can not make legally binding decisions. They are not involved in day to day supervision.

Moves to enhance their role have generally been resisted by the Commission (who want to retain maximum power over regulation themselves) and by Member States (who want to retain supervisory powers to themselves as a national competence according to the Treaties and because it is taxpayers who pay the consequences). The Parliament has proposed an EU superstructure enhancing the role of the level 3 committees which looks a practical way forward.

Unfortunately in the vote in committee on Solvency II members did different things to what they agreed in the report, showing how difficult it is to break through the Member State mindset when it comes to actual legislation. In the recent Council debate, in reply to [Graham Watson](#), the Lib Dem MEP and Leader of the Liberal group in Parliament, and Marielle de Sarnez, both promoting a 'European Financial Services Authority' Sarkozy explained the reluctance of Member States and how this restricted proposals to the practical and achievable.

Hedge Funds and Short Selling

Everyone loves to hate hedge funds and blame them for everything that's gone wrong. This in many respects a free shot for populists.

They certainly were not the cause of the crisis - they have been victims in that they owned a lot of the dodgy stuff and so lost value. However as market players with high leverage the effects on them have also had other knock on effects: they have had to deleverage rapidly, pay a lot of money in to banks and brokers who were calling in everything they could. This meant they had to sell a lot of shares and bonds, causing prices to fall further. Recent evidence from the US suggests that the bans on short selling, intended to protect financial institutions, forced still more selling with further negative consequences. More hedge funds will probably collapse leading to more shocks to the system.

Parliament's reports have called for all financial institutions to be regulated, but it is made clear that this should be done according to function and risk. The Commission is undertaking a comprehensive review for regulatory 'lacunae' as requested by the Parliament.