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REGULATORY ASPECTS OF THE RECENT TURMOIL IN THE FINANCIAL MARKETS

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Regulatory Aspects of the Recent Turmoil in the Financial Markets

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The recent turmoil has highlighted the need for adjustment of the standards set for financial markets in the light of fluctuating risk profiles. This paper analyses the driving factors and outlines possible responses. It is concluded by some thoughts on the future structure of supervision and supervisory authorities.

Keywords: Accounting standards, Basel Committee, Basel II, CRD, cross-border supervision, financial intermediaries, financial markers regulation. IAS, IOSCO, large exposures, liquidity management, marking to market, monetary policy, rating agencies, regulatory arbitrage, reporting standards, risk models, structured credit, subprime mortgages, valuation standards.
JEL-Classification: G 15, G 18, G 24, K 23.

1. The Economic Sequence of the Crisis

Banking organisations and securities firms entered the turmoil in relatively sound condition and generally with capital well above regulatory requirements [1].

The primary source of losses came from concentrated exposures that some major financial services organisations had in U.S. subprime mortgage-related credit. Credit to the real estate sector accounts to 1/3 of the total balance-sheet assets of the U.S. banking system. The subprime sector thereof – loans to borrowers with eligibility criteria or a credit history below average benchmarks – is estimated at approx. USD 1.4 trillion. With house prices starting to decline, it became clear that a great deal of subprime loans could not be repaid by the proceeds of house sales as was previously the case. At the same time, USD 800 bn are or will be scheduled to interest adjustment in an environment of rising rates in 2007/2008, often initially granted at teaser rates with rolled up interest. From November 2006 to 2007 alone, U.S. home foreclosures rose by nearly 70%.

Following the "origination for distribution" business model, mortgage and in particular subprime exposures had been largely securitised and sold to market participants, frequently outside the regulated banking sector:

- conduits and structured investment vehicles (SIVs) funded by short-term commercial papers;
- CDO underwriters;
- hedge funds;
- pension funds;
- insurance companies.

A great deal of such securities was structured in a way that made them highly exposed to the risk of a decline in U.S. house prices. This was driven and exacerbated by over-liquidity in the markets – investors were seeking out higher-yielding investments which they found in synthetic securities transferring even more subprime risk to investors than was originated in the underlying primary markets [2].

Due to the realisation of subprime risks, some investment vehicles failed, causing a sudden pullback in short-term lending to the sector. The result was a shift from a credit event to a liquidity event, because such vehicles had been funding their long- or medium-term investments in mortgage backed securities by short-term borrowing. Many investment entities had to dispose of their securities, even prime and performing. Many types of related credit investments became illiquid during the time, causing sharp decreases in secondary market prices and requiring corresponding markdowns in the valuation of firms' holding of affected assets [3]. Related write downs under the principle of marking-to-market had to go through profit and loss accounts and balance sheets affecting the capital base of the firms concerned. The consequence was a further shift from a liquidity event to a solvency event.

Once investment vehicles came under stress, they transmitted the shock to the broader financial markets, in particular banks and investment firms. Some firms were required to fund contractual commitments to off-balance sheet investment vehicles which they had not anticipated they would have to fund themselves. In other cases, firms under no contractual obligation still provided support and/or funding to vehicles they had sponsored because of concerns about the potential damage to their reputations, or took them onto their balance sheets [4]. This included retaining exposures in warehouse portfolios for significantly longer periods of time than expected when firms realised they were unable to find buyers for securities to be issued [5]. Interbank interest rates rose sharply [6].

By now, with many securitisation markets effectively closed, assets are accumulating on bank balance sheets. Together with valuation losses on mortgages and other assets, this is stressing capital positions and contributing to tightening credit conditions. Hoarding of liquidity and counterparty concerns have led to a shortening of banks' funding profiles, causing severe stress in interbank and other lending markets.

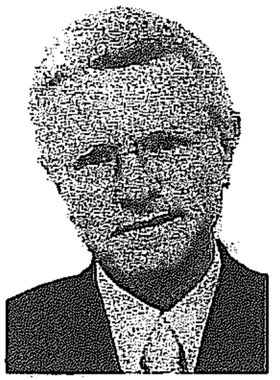

Photo: private

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[1] *BCBS* (2008b), p. 2.
[2] *BCBS* (2008b), pp. 5.
[3] *Senior Supervisors Group* (2008), p. 2.
[4] *BCBS* (2008b), p. 2; *Senior Supervisors Group* (2008), p. 2.
[5] *Senior Supervisors Group* (2008), p. 2.
[6] The spread between the 3 months LIBOR and the official policy rate was at 95 bps in the Euro zone by mid-December 2007 resp. at as much as 115bps in the UK by mid-September 2007.