

Capital markets & market turbulence: the problem and the response

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On February 18th **PRiM**, **ALGAFI** and **The Directors' Office** invited Mr René Karsenti of ICMA (International Capital Markets Association) to lead a discussion on a topic close to all hearts and minds at this point in time. "Capital markets and market turbulence: the problem and the response," was his subject, so it comes as very little surprise that the auditorium at Fortis Bank Luxembourg was packed for this the latest of PRiM's lunchtime conferences.

ICMA is a 40 year old self-regulatory organisation with 400 members across 50 different countries. Over the last four decades ICMA hard worked hard to, *"ensure the smooth functioning of the capital markets...maintain a resilient, efficient and stable infrastructure...limit unnecessary regulation that could restrict innovation and efficiency."* As such it has been a close observer of the highs and lows of the capital markets during this time and is well positioned to offer some practical advice.

Karsenti's first remarks were about the causes of recent market turbulences; basically, massive uncertainty about sub-prime losses and credit quality sparked by the crisis in the US. *"The sub-prime crisis quickly spread across the international financial system,"* he said, *"but it is essential that we are clear about the underlying cause, which was significant structural weaknesses."*

Karsenti put the issue into some perspective. He said that the recent turbulence came about at a time when there was an explosion of credit growth during a period of strong economic expansion and low interest rates, which lead to an enormous global demand for yields from investors. *"Looking back, access to credit was too easy for too long accompanied by too much over-leveraging. Not only that, but the increase in securitisation meant that many non-banks also became a source of credit. Then there was the banks' inability to cope with maturity and liquidity transformation, as well as too great a reliance on credit ratings."*

"The result of all this was that credit risks were mispriced and some SIVs were unable to roll over their funding. Then some banks had to make the decision to take off-balance sheet assets back on to their balance sheets and this de-leveraging led to forced asset sales." The problem then became uncertainty about where losses lie, which lead to a lot of market speculation. *"So far,"* said Karsenti, *"losses of 120 billion US dollars has been reported by banks, but this could potentially go up to around 400 billion (G7 & Tokyo)."*

Karsenti believes that this issue will undoubtedly affect real economic growth in the US given that, *"US consumers spend 9.5 trillion US dollars, representing 72% of GDP, and there is now a chronic shortfall in US savings."* Although he is not yet certain how large this downturn will be, he is more than certain that it will affect Europe. *"After all, Europe is still heavily dependant on exports to the US."*

For the future stability of the markets, Karsenti feels that, although the central banks were correct to intervene, their challenge now is to maintain confidence in the markets without giving the impression that they will always bail out individual institutions or that they encourage risk taking. *"As for the banks themselves, many have had to rethink off-balance sheet vehicles, taking them back on, and now must pay greater attention to risk control and management. Many banks have also needed to raise more capital and sovereign wealth funds have been playing an important role in this."*

"The market has now become a lot more cautious and much less highly leveraged," he continued, *"there is less quantity as risk is being re-priced."* He was pleased to note that, *"there is now a greater emphasis on credit quality and issues with weaker covenants are difficult to sell to investors."*

Looking to the future, Karsenti recommends a review and closer monitoring of ratings agencies. Indeed European authorities have called for new arrangements with credit ratings agencies as well as greater transparency in the financial markets (although lack of disclosure has not been cited as one of the causes of recent shocks).

Karsenti summed up by making the following recommendations for further actions in the light of the current crisis:

- Define the causes and weaknesses revealed by the market turbulences.
- Draw up a joint industry/regulator response to strengthen the resilience of key elements of the financial system.
- All market players (central banks, banks, ratings agencies & investors) must accept their roles and responsibilities following this revision.
- Develop an early warning system to improve the ability to respond to crisis.

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