

## EPFSF Briefing

# Recent Market Turbulence: Causes and Consequences

Global financial markets have experienced a challenging and protracted period of credit market turbulence and some knock on equity market volatility. Market participants, regulators and policy makers now face the challenges of restoring confidence, market liquidity and functioning. Macroeconomic, financial sector and individual firm outlooks remain challenged by weaker economic outlooks in some regions, rising commodity prices and inflation pressures, re-pricing risk and deleveraging, capital raising and restoring the health of balance sheets.

### Underlying Causes

The root causes of the current turbulence are the state of the US housing market and the excessive extension of credit to the sub-prime sector. While it is easy to point to the lack of regulation of US-based retail mortgage brokers as a major factor, there are a number of inter-related forces that contributed to the market turbulence.

Global financial markets have been awash with liquidity, reflecting the excess savings from Asia (in particular China) and excess cash from energy producing countries. This liquidity and competitive factors in the financial market-place led to credit risk mis-pricing in key market segments. Financial instruments have also become more complex for a variety of structural, technological and behavioural reasons. Finally, contagion patterns have emerged during the current turmoil, the speed and reach of which have not been witnessed in earlier periods of financial instability.

### Underlying weaknesses

The Financial Stability Forum (FSF) published a report on 12 April which identified the following key weaknesses of the financial system.

**Poor underwriting standards:** Business volumes grew more quickly than did investments in the supporting infrastructure of controls and documentation. Misaligned incentives were most conspicuous in the poor underwriting that proliferated in the US subprime mortgage sector, especially post 2004. The combination of weak incentives, an increasingly competitive environment, low interest rates and rapidly rising house prices led originators and mortgage brokers to lower underwriting standards and to offer products to borrowers who could often not afford them or could not bear the associated risks. Weak government oversight contributed to the rise in unsound practices, especially by mortgage companies not affiliated with banks.

**Shortcomings in firms' risk management practices:** Some of the standard risk management tools used by financial institutions are not suited to certain types of structured products. A number of financial institutions had weak controls over balance sheet growth and off-balance sheet risks; inadequate aggregation of risk across business lines and functions; and weak understanding of the risks inherent in mitigating those risks.

**Poor investor due diligence:** Many less sophisticated investors did not sufficiently examine the assets underlying structured investments. Weak due diligence practices further fuelled the issuance of complex structured credit products. In conducting their due diligence, many investors placed excessive reliance on credit ratings.

**Credit rating agencies (CRA) performance in respect of structured credit products:** The FSF raises concerns about weakness in rating models' methodologies; the level of due diligence of the quality of the collateral pools underlying rated securities; transparency about the assumptions, criteria and methodologies used in rating structured products; information provision about the meaning and risk characteristics of structured finance ratings; and conflicts of interest in the rating process.

**Incentive distortions:** The FSF has concluded that shortcomings in risk management, risk assessment and underwriting reflected a variety of incentive distortions:

- Originators, arrangers, distributors and managers in the OTD (originate-to-distribute) chain had insufficient incentives to generate and provide initial and ongoing information on the quality and performance of underlying assets.
- The Basel 1 capital framework encouraged banks to securitize assets through instruments with low capital charges.
- Compensation schemes in financial institutions encouraged disproportionate risk-taking with insufficient regard to longer-term risks.

**Weaknesses in disclosures:** Weaknesses in public disclosures damaged market confidence. Public disclosures did not always make clear the type and magnitude of risks associated with their on-and off-balance sheet exposures.

**Feedback effects between valuation and risk-taking:** The turbulence revealed the potential for adverse interactions between high-leverage, market liquidity, valuation losses and financial institutions' capital.

**Weaknesses in regulatory frameworks and other policies:** Limitations in regulatory arrangements, especially pre-Basel II, contributed to the growth of unregulated exposures, excessive risk-taking and weak liquidity risk management.

## **Responses from policy makers**

The FSF makes proposals in the following five areas:

- Strengthening prudential oversight of capital, liquidity and risk management;
- Enhancing transparency and valuation;
- Changes in the role and uses of credit ratings;
- Strengthening the authorities' responsiveness to risks; and
- Robust arrangements for dealing with stress in the financial system.

In addition to these global measures, in October last year ECOFIN agreed a Roadmap prepared with the assistance of the European Commission. The roadmap consists of a working programme, aimed at reviewing, along with the EU's international partners, how to further improve: (i) transparency; (ii) valuation standards; (iii) the prudential framework, risk management and supervision, and (iv) market functioning, including the role of CRAs and the treatment of "non-organised debt markets" (i.e. how MiFID and other Directives (Prospectus Directive, Transparency Directive and Market Abuse Directive) may or may not apply to ABS, ABCP and CDS products). At the informal ECOFIN in April this year, Ministers and Governors issued a statement stating that good progress was being made in the implementation of this road map. In addition the statement detailed the ongoing tensions in international financial markets and the appropriate policy response:

- To improve **valuation standards**, they urge supervisors and accounting standards-setters to ensure that the financial reporting framework functions properly with clear guidelines on valuation that can be applied consistently across institutions.
- To strengthen further the existing **prudential framework and risk management** in the financial sector, the Commission will propose a revision of the Capital Requirements Directive in September 2008 for adoption by April 2009 at the latest. The revision will address elements of the prudential treatment of securitization, as well as the large exposures regime and hybrid capital instruments.

- On **credit rating agencies** Ministers and Governors urge the industry to present as soon as possible a roadmap of planned industry wide initiatives. Before summer 2008 the ECOFIN Council will discuss a Commission assessment of the role of credit rating agencies in structured finance and the process of rating complex financial products, taking into account international developments (such as revisions to the IOSCO Code of Conduct). If market-led solutions prove inadequate Ministers and Governors stand ready to consider regulatory alternatives.

### **Response from the market**

The European financial industry has a stake in ensuring that the market turbulence is resolved as quickly and orderly as possible. There are a number of industry initiatives underway to improve the availability and accessibility of data on structured credit markets for regulators and market participants, including: (1) beginning June 2008, the provision of a comprehensive periodic report containing market data on the EU securitisation market; (2) guidelines on good practice in implementing the securitisation disclosure requirements in the Capital Requirements Directive; and (3) initiatives to improve investor access to deal information in both the term securitization market and the ABCP market.

Beyond market-led solutions on information disclosure and data accessibility, the European financial industry is looking to respond further by developing industry-wide solutions (such as codes of conduct) in addition to individual companies taking measures to enhance risk management, stress testing and risk assessment system etc, themselves.

In addition, CRAs have announced self-regulatory actions to address concerns raised. On valuations there have recently been announcements of market-led solutions by NYSE-Euronext and Reuters, as well as Markit Group's multi-dealer valuation platform. Markit's system will aggregate valuations and offer buy-side clients access to a composite of sell side valuations. This will allow buy-side clients the opportunity to compare valuations and increase market transparency.

### **Conclusions**

The financial services industry is supportive of the recent policy proposals by ECOFIN and the FSF. The problems in financial markets are international and therefore require global policy responses. It is important that the policy response remains considered and that policymakers stay close to what is happening in the financial markets and understand what industry themselves are doing to improve the financial climate. Delivering results that will enhance market efficiency and financial stability will therefore need a mixture of action by policymakers, industry and individual firms.

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Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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