The darkest hour is just before dawn

JOHN WALKER DESCRIBES HOW THE GLOBAL FINANCIAL SITUATION HAS DEVELOPED INTO A CRISIS OF MAGNITUDE THAT WAS UNIMAGINABLE JUST SIX MONTHS AGO.

"The darkest hour is just before dawn," sang The Mamas & The Papas. Let's hope that they are right but just now it feels more like midnight.

This is the third article I have written for The Treasurer in what has become a series tracking the financial meltdown. It kicked off with "What a summer" in the November 2007 issue and moved on to "A winter of discontent" in May 2008.

A year ago I wrote that the crisis would not end until investor confidence had returned and that would not happen until the bad news was off the front pages. Far from being off the front pages, the financial crisis now completely fills them and many others besides.

The sub-prime bubble has now expanded into a full-blown global banking crisis of a magnitude that was unimaginable a year or even six months ago.

HOW DID WE GET HERE? The popular myth is that the crisis started to unfold in August 2007 but the first symptoms were appearing in late 2006 and early 2007. In truth, the crisis had been in the making for a decade. In general, the US has been blamed for creating a sub-prime property bubble in which too much money was lent on the security of poor-quality housing to aspiring home-owners who had no hope of servicing the debt once interest rates started to rise. An asset bubble had been created.

These loans were parcelled up and the rating agencies persuaded that there was strength in numbers and diversity so that bundles of these sows' ears could be made into silk purses for resale.

This is, of course, a jaundiced view of securitisation, which is the means by which loans were bundled and distributed to investors and banks around the globe.

Obviously, not all securitisation consisted of sub-prime dollar mortgages but it has all been tarred with the same brush. It is said that sub-prime mortgages account for more than $2.0 trillion.

WHERE ARE WE NOW? Nearly four million US citizens have had their homes repossessed.

Investors' lack of confidence has not been assuaged and the breakdown of the interbank market has intensified rather than eased.

The problem has become global. During 2008, more than 20 banks have failed in countries such as the US, the UK, Germany, France, Belgium, Holland and Iceland. Some have been rescued, some have been taken over, some have been nationalised and some have been allowed to fail.

Famous names have gone, such as Bear Stearns and Lehman Brothers.

The rate of failure has accelerated, with five banks failing in one day in September. In recent weeks the central banks have announced bailouts aggregating to the equivalent of £1 trillion.

The central banks are now forced to stand between the rest of the banks as a kind of clearing house for interbank loans and deposits since the banks fear to lend to each other. The domestic and international money markets no longer function.

Governments and central banks have taken concerted action to support the banking system, pumping in hundreds of billions of pounds and reducing interest rates in a co-ordinated way. So far to no avail.

Asset values including house prices are collapsing, and equity markets are crashing around us.

At the time of writing attention is turning from failing institutions to failing nations, with Iceland, Pakistan, Ukraine and Hungary all under pressure.

The head of the IMF has warned that the global financial system has been pushed "to the brink of systemic meltdown". Dawn seems an awfully long way away.

SHOULD THE CRISIS BE A SURPRISE? A brief look back into history is a sobering experience. Asset bubbles and bank failures have been a recurring problem.

Starting with the Tulip Crash in the Netherlands in 1637, one major financial disaster has succeeded another. More recent highlights include:

- Railway Bubble, 1844;
- Wall Street Crash, 1929;
- US Banking Crisis, 1933;

THE BASEL II BANKING STANDARDS HANDED OVER THE MEASUREMENT OF RISK TO LEADING BANKS, WHICH WERE DEEMED TO HAVE DEVELOPED SOPHISTICATED SYSTEMS FOR MONITORING RISK. IT WAS RATHER LIKE LEAVING WINNIE THE POOH IN CHARGE OF THE HONEY POT.

Executive summary

- It is inevitable that the financial sector will have to submit to tighter regulation and possibly a return to a Glass-Steagall type of structure. Sadly, the sector has shown that it cannot be trusted to cope with the conflicts of interest that integration engendered. In addition, banking will become a duller and more staid existence, with innovation discouraged. It may even cease to be a career destination for the brightest young graduates.

- UK Secondary Banking Crisis, 1973;
- Latin American Debt Crisis, 1982;
- US Savings and Loans Crisis, 1985;
- Stock Market Crash, 1987;
- Scandinavian Banking Crisis, 1991;
- Japanese Banking Crisis, 1993;
- East Asian Crisis, 1997;
- Russian Debt Moratorium, 1998; and
- Dotcom Crash, 2000.

It could be argued that another crisis of some sort was long overdue and that the time-lag since the last major bust has contributed to the severity of the current one.

In May 2002, Jean-Charles Rochet, professor of mathematics and economics at Toulouse University, gave a lecture entitled, "Why are there so many banking crises?" Expanded and subsequently published, the book of the same name offers a fascinating read in the context of the crisis that we are now witnessing.

In each case the crisis followed an asset bubble. In several cases the crisis was sparked by deregulation in some form and was fuelled by imprudent real estate lending and the human weakness of greed.

WHY HAS IT TAKEN SO LONG TO GERMINATE AND WHY IS IT SO SEVERE?

- **Market expansion** To state the obvious, banks are structurally disadvantaged in that at no time can they repay all their depositors simultaneously, yet they depend for their existence on confidence that they can repay deposits whenever required. In order to protect depositors, banks had to work to a set of prudential ratios which placed a physical limit on the expansion of bank balance sheets.

But following the 1999 repeal in the US of the Glass-Steagall Act of 1933, banks developed the securitisation models which enabled them to increase the volume of business without expanding their balance sheets. Buzzwords such as CMBS, CDO, CMO and SIVs entered the banking vocabulary. Financial engineering certainly delayed the onset of the adverse symptoms of overtrading until the floodgates broke.

The growth of credit default swaps since 1997 enabled banks to transfer risk from their own balance sheets to non-banking institutions. It is estimated that the size of this market has grown to a staggering £32 trillion. In 2002, US billionaire investor Warren Buffet described derivatives as "timebombs, both for the parties that deal them and for the economic system" and "financial weapons of mass destruction".

Most of the crises listed above have a regional connotation. But securitisation allied to globalisation had led to the disintermediation of risk around the world, which has increased and extended the contagion immeasurably. All that is now becoming only too evident.

- **Regulation** Buffet also said that central banks and governments have "no effective way to control, or even monitor, the risks posed by these contracts".

Similarly, central banks and governments had no way to measure the growth of liabilities and assets that were growing off the balance sheets of the banks that they regulated.

The Basel II banking standards handed over the measurement of risk to leading banks, which were deemed to have developed sophisticated systems for monitoring risk. It was rather like leaving Winnie the Pooh in charge of the honey pot.

Before the self-regulation regime of the Securities and Investment Board gave way to external regulation by the FSA in 2002, the style of oversight included some very uncomfortable interviews and

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reviews in the portals of the Bank of England. But such interventions by the financial authorities are no more. Statutory regulation has introduced a fear among regulators of expressing an opinion, and regular interaction between the regulated and the regulators has disappeared to the detriment of the system as a whole.

The intermingling of the supervision conduct of business and risk management is a fundamental weakness.

The quality of regulation has also undoubtedly been poor. A cursory glance at websites would have revealed that prudence had been sent packing.

- **Accounting standards** In the quest for transparency, the accountancy profession has developed reporting standards to which the major developed countries adhere. These involve marking to market the assets and derivatives (used for trading) to which the reporting institutions admit. Each time an institution marked down the instruments, it set a new level to which others could comply. This accelerated the slide into insolvency of US banks where the implementation of such standards exacerbated the problem.

If these accounting standards had been in place in the 1990s, the Japanese economic structure would have collapsed as a result. In the event, the Japanese banking system took 10 years to work off the excesses of the 1970s and 80s.

- **The media** The media have had a feast. Depositors have been spooked and have reacted accordingly. The column inches devoted to the financial meltdown have kept the newspapers afloat. The reporting of the unfolding crisis has been both sensational and negative. As the central banks announce packages of assistance, the media reaction is to wheel out a team of experts to analyse and explain why they may be doomed to failure rather than why they might succeed.

The BBC's business editor Robert Peston has become a star with his nightly appearances on the news.

All of us, except for the treasurers of certain local authorities, have become immersed in the implications of the unfolding crisis.

- **Denial** By general consensus, the securitisation market closed in July 2007, although the banks expected it to be a temporary pause before reopening in the first quarter of 2008. In anticipation, they continued to build assets, confidently expecting to offload them when the market reopened. It didn't and still hasn't, leaving the banks with the burden of unusually loaded balance sheets.

ARE THE AMERICANS ENTIRELY TO BLAME? The sub-prime bubble is a generic term and represents just the tip of a global iceberg of overvalued assets.

The integration of banks and securities firms took place in London more than a decade before the repeal of Glass-Steagall.

And Northern Rock created its own toxic portfolio of assets without having to buy sub-prime mortgages from US.

The blame lies fairly and squarely with UK management, and not with the Americans.

THE RESCUE OF THE SYSTEM The politicians share the rage of the public but it is essential that the financial system be protected as it is central to the economic structure of the major industrialised countries. The alternative is the collapse of capitalism as we know it.

The Americans have announced the purchase of toxic assets from the banking system aggregating $700bn. The UK has announced a package aggregating £500bn in the form of liquidity, equity and the guarantee of maturing interbank loans. Other governments have enacted rescues ranging from nationalisation to the guarantee of bank undertakings. As I write, a co-ordinated European rescue along the lines of the UK model is being developed.

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WILL IT WORK? By the time you read this we may know, but for the moment it is too soon to say.

So far we have been fed with statements of intent and political rhetoric. The money has not yet started to flow.

It seems that something needs to be taken from both the American and the UK models, so that they begin to look more like the Scandinavian model.

In the Scandinavian banking crisis of 1991, the governments affected recapitalised the banks and, in effect, nationalised the "bad assets". With changed management, the banks were able to get back to business.

The current financial crisis is on a much larger scale, but to avoid a lingering recession it is essential that the banks return to the market and support commercial undertakings.

HOW WILL WE KNOW? The first signs will be that the interbank markets start to function and the relationship between certain key interest rates return to normal parameters.

FUTURE THREATS The aggregate of the securitised loans created over the last decade is far greater than the banking system may absorb should they return to the balance sheets of the surviving banks.

Similarly, the vast array of derivative instruments will need to be settled when due.

It is inevitable that the financial sector will have to submit to tighter regulation and possibly a return to a Glass-Steagall type of structure. Sadly, it has shown that it cannot be trusted to cope with the conflicts of interest that integration engendered.

Banking will become a duller and more staid existence with innovation discouraged. It may cease to be a career destination for the brightest young graduates.

A FLUID SITUATION The situation is very fluid but it is now clear that governments have come to a consensus that only collective and co-ordinated solutions will be effective in protecting the system.

Perhaps when you read this, the dawn will indeed be nigh.

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