Triple Whammy on the Credit Markets

Nicolas Véron

Originally published in French in *La Tribune*, 17 September 2007

Financial crises are generally caused by imbalances and speculative bubbles, but their impact is made much greater when they are wrongly read and managed. The current developments are especially worrying, because they are unprecedented. Risk has never been as scattered as is today, as a result of financial innovation and globalisation. Confusion over different drivers of the turmoil risks worsening the fall-out. And there are at least three such drivers.

The first driver is the bursting of the housing bubble in some regions of the US. This aspect is the easiest to grasp, since it is neither the first nor the last event of its kind. It is also the one with the most immediate consequences on the economy. The housing downturn may have a recessionary impact, and the US Federal Reserve must respond by making sensible use of the tried and tested tools of monetary policy. For the moment, Europe is not directly impacted. Its financial exposure is limited to a number of banks with investments in the subprime segments reaching a few dozen billion euro at most: a painful reverse, but not enough to rock the macroeconomic boat.

The second driver is unease about banking business models. The turmoil has confirmed the central place of banks in the financial system, despite the amount of ink devoted to hedge funds and private equity over the past few years. Some hedge funds have floundered in recent days, but it is through banks that the funds' problems may become systemic. It is easy to overlook how dominant the banking sector is. At the end of June, financial services (most of which is banking) represented 28% of the aggregate market value of the FT Global 500 companies, and 29% of the European share of this sample. But markets are realising that the banking sector is largely a black box. As a survey of Goldman Sachs by The Economist in April 2006 illustrated, the information published by the giants of investment banking does not allow one to understand the risks to which they are exposed. With the collapse of the German banks IKB and Sachsen LB, the world discovered with horror the huge off-balance-sheet commitments of medium-sized banks, through 'conduit' vehicles which almost no one had previously heard of. A first level of policy response would lie in tightening up prudential control, in particular by centralising supervision at European level for those banks whose activities are spread between many European Union countries, such as UniCredit and Santander. This is up against enormous institutional inertia but needs to be implemented urgently in order to properly manage future bank failures in Europe. Because of their systemic importance, banks should probably also be required to supply more public information on their risk profiles in order to calm fevered markets, as was suggested recently by Josef Ackermann, the head of Deutsche Bank.

This brings us to the third driver, perhaps the most difficult, which is the deficit of credible information on financial risk. It is just as perilous to invest in a security on the sole evidence of its credit rating as it is to buy a company's shares on the sole basis of its profit of the last financial year. This information is relevant but the investment decision requires reading it together with other data. Many investors have apparently attached too much importance to credit ratings. Moreover, while profits are at least theoretically measurable, credit ratings only express a probability which can by definition never be individually verified, even *ex post*. But what additional risk information should be given to the markets? The often-heard plea for more regulation of rating agencies does not answer this question.

In order to fight the disease, one must first understand it. Some policymakers, like medieval physicians, claim to have a diagnosis, but all they are able to do is to point the finger: to rating agencies, central banks, hedge funds or other evil 'speculators'. By contrast, the real issue is to allow markets to understand banking business models, and to give them proper information on financial risk. This is a difficult challenge. It will not be met by political posturing, but by time-consuming analytical work. With every passing week, it becomes clearer that the response to this challenge will determine the crisis' outcome.

Nicolas Véron is a Research Fellow at Bruegel.