The turmoil in financial markets worldwide has many worrying about their national economies. Adrian Holloway asked Professor Viral Acharya to identify the best path to fiscal stability. Before all else, says Acharya, we need to untangle the banking mechanisms increasingly used in the last decade.

Risky business
It has been an extraordinary period for financial markets worldwide, beginning in June 2007, when investment bank Bear Stearns revealed huge losses from beleaguered hedge funds linked to US sub-prime loans. Next, Newcastle-based Northern Rock Bank experienced severe liquidity problems, as the commercial paper market on which it relied for financing dried up, causing a run on the UK bank – the first in 150 years.

This prompted an unprecedented move by the chancellor, Alistair Darling, promising to guarantee savers against losses on their deposits. The Bank of England, the US Federal Reserve, the European Central Bank and national banks of Canada and Switzerland all slashed interest rates and offered further liquidity to associated banks in an effort to inject confidence into the global money markets, pledging more cuts if needed. And not much later, stock markets globally experienced extraordinary volatility, with some of the sharpest plunges witnessed in some time, forcing the US Federal Reserve to engage in a series of further interest-rate cuts and to request the US government for a fiscal stimulus package.

An astonishing sequence of events, all attributable to the current global credit crisis that has become a major focus of public concern and proved to have far-reaching repercussions.

Making sense of the mess
According to Viral Acharya, Professor of Finance and Academic Director of the Private Equity Institute at London Business School, to make sense of the current credit crisis, you first need to untangle the often Byzantine banking mechanisms that global banks have increasingly employed in the last 10 years.

“Some of these mechanisms have genuinely transferred the risk out of bank portfolios. Credit derivatives and securitization were developed precisely to serve this purpose. By and large, these mechanisms are helpful and good for the economy. It’s very useful to have credit risk shared, and this kind of risk sharing helped the global financial system absorb the recession of 2001-02 rather well.”

In the grand scheme of things, Acharya says the volume of US sub-prime loans that have gone bad, and the losses so far incurred by the banks (at least $100 billion) are actually modest. “Keep things in perspective. Sure, $100 billion is a large sum of money, but remember these losses are shared by at least 50 large banks. What is much more hidden and interesting – though obviously distressing for investors – is the difficulty in establishing just where all these pieces of bad debt lie in the financial system.” He continued, “You might have a very good idea about who originated a loan. But a large fraction of these losses will be off-balance-sheet. Banks do not have to disclose the nature of even their direct loans. It’s proprietary information. And while there is some disclosure of off-balance-sheet assets and liabilities in filings, it reveals woefully little about their exact nature and risks.”

Like company reports, bank balance sheets can be opaque at the best of times. Given the skilful packaging of debt through the banking system, this means suspicion, when it arises, is often dispersed. Plainly, part of the credit crunch problem is about clear disclosure and good transparency. And for the average retail customer, Acharya says, it is particularly hard to understand just how vulnerable their bank of choice might be to bad debt. Even banks themselves are worried about lending to each other, in case they expose themselves to more bad debt that can’t be repaid. “But I wouldn’t say it is panic, in the sense of some irrational freeze in the market,” says Acharya. “You have to remember these banks who lend to each other are very sophisticated players indeed.”

The dark side of credit risk transfer
Acharya contends there is another darker side to the credit risk transfer issue. Much of the risk that looked as if it had been transferred off bank balance sheets was never transferred at all, certainly not in any meaningful sense. “When banks transfer risk off-balance-sheet, it also means they attract capital relief from a regulatory standpoint. This manoeuvre is often accomplished through tax-efficient measures such as Structured Investment Vehicles (SIVs) in which banks, by placing billions of debt

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off-balance-sheet, can continue to lend more money.” Last year The Economist estimated there were €2 trillion of this type of debt outstanding.

Such SIVs are funded by short-term asset-backed commercial paper, generally up to 12 months, and there is often a high degree of mismatch between the maturity of their assets (loans) and their liabilities (commercial paper). Of course, when there’s plenty of cheap credit available and the likelihood of default is low, this type of strategy works well. But when a crunch occurs and liquidity dries up, such structures provoke a great deal
more scrutiny – and worry – for the originating banks. “The trouble starts when credit risk transfer is part of a regulatory arbitrage game rather than an economic risk transfer,” says Acharya. “Let’s say a bank sets up a SIV, to which it transfers loans. On paper, it looks like an off-balance-sheet transaction. But if the SIV gets into problems, it can still draw down a line of credit from the bank. Now, when the SIV needs liquidity, what does this mean for the bank? Effectively, the bank is still exposed to the loans it apparently moved off-balance-sheet. The SIV may have produced capital relief for the bank, but in an economic sense, they haven’t actually transferred the risk out of their balance sheet. I’d say this is where the lending model went wrong – and why we’re partly in the mess we’re in now.”

It’s also obviously a joint problem for both financial regulators and institutions. Acharya doesn’t think regulators themselves have yet grasped the seriousness of the SIV problem – or not until very recently. Nor have they anticipated the rapid transmission of these ripples through the global financial system, caused by SIVs drawing down significant lines of credit from parent banks. “If banks are worried about significant drawdowns on credit lines, they stop providing liquidity to back new commercial paper issuance. In fact, this time around, they are hoarding liquidity to the point that they are unwilling to lend to each other.”

This same lack of trust has, of course, seeped deep into the global financial markets as the full scale of the volume of poor quality US sub-prime loans, much of them backed by SIV commercial paper, became more widely known. Acharya says that, even though many people felt bad loans were being made, US banks continued securitizing these loans in order to generate regulatory capital relief. “You could still make the commission fees, especially with large volumes, and think – or perhaps just make it seem – that you were not bearing too much risk.” But with many players now so heavily leveraged, comparatively small shocks in the system, such as defaults on US sub-prime loans, can have a disproportionately large impact.

Managing the crisis
The credit crisis has many tentacles, some of which extend to other areas, including the industrial sector. Could the crisis also strangle conventional commercial lending? In the US, consumer spending is certainly falling. Worry about tightening bank credit lines has caused a backlog of merger deals, in particular for large private equity transactions. And while central banks globally have more or less simultaneously slashed interest rates, Acharya says this inevitably places greater pressure on inflation. These measures can also create awkward moral hazard questions for both lenders and central banks. “Given the depth of the current crisis,” says Acharya, “central banks are perhaps left with little choice. However, once the crisis abates, the regulators are certain to revisit banks’ internal governance procedures and to ask whether the current disclosure and regulatory treatment of off-balance-sheet structures serve their intended purpose. It may be more prudent and practical to take measures that will reduce the likelihood of crises in future, rather than address moral hazard questions during crises.”

Meanwhile, some of the banks have begun to deal with the damage by gradually reducing their own exposure to risk, says Acharya. “We’ve seen this recently with Citigroup selling some of their off-balance-sheet SIV exposure to the rest of the market and simply taking the hit on the rest by buying it back. As I’ve already said, at the outset it might have appeared to be a transfer of economic risk, but their SIV had the ability to draw down funds from Citigroup. Now they’re getting it off their books in a clean way and they’re no longer selling it on to their own vehicles.”

Other lenders such as HSBC and Société Générale are also thought to be taking more control of their SIV obligations. More write-downs are still expected with many banks’ capital-to-debt ratio continuing to fall. But to whom are the banks selling their SIV paper? Some buyers will be hedge funds flush with cash, says Acharya, while others will be those banks less exposed to the credit debacle. “These private trades are also completely anonymous. The real problem, of course, is that there are just too many banks all liquidating the same kind of asset in an attempt to de-leverage their balance sheets. I predict it will be at least six months to one year before we see the losses completely out of the way. That’s because the process of clearing several billion in off-balance-sheet assets and dispersing it properly to the rest of
the market, rather than on paper, should have happened over the last two or three years, rather than in the past few months.”

Learning a hard lesson
So, where does this leave us? What lessons have the financial regulators learned? Is more financial transparency needed; and, if so, how much? And how could lending be more effectively policed?

The financial authorities will probably feel that the banks need to be far more proactive in assessing and disclosing the mismatch between assets and liabilities, says Acharya. “It’s about knowing what the balance sheet looks like now, and more importantly, what it could look like in the future when contingent liabilities such as drawing down of lines of credit arise. And yes, this would require more sophistication from the financial authorities, too.”

Acharya says there could also be changes made to make it easier for central banks (in particular, the Bank of England) to have more authority in terms of a possible sale of a financial institution. In this crisis though, most bank balance sheets had been so highly levered that nationalizing troubled banks and selling them in future when the crisis has abated may be the most pragmatic and effective response. Another issue, he says, is that if the tripartite regulatory arrangement in the UK between the Treasury, the Bank of England and the Financial Services Authority (FSA) is to work better, they need to communicate seamlessly. “There should be clear communication between the supervisor and the lender-of-last-resort. Most economic rationales suggest these two parties need to rely on each other very closely indeed.”

The other big question won’t be answered for a while yet: just how probable it is that the global credit squeeze will trigger a global recession. So far, it looks likely that the US would suffer first and deepest should conditions deteriorate further; many US mortgages bought in the last two years on special “teaser” rates will re-set in 2008, and so payments for many Americans will rise. “A month or two ago,” says Acharya, “people thought the crisis would take perhaps six months to settle down. Now, many think it could be a year.

“My sense is that the Fed and other central banks are trying hard to kick-start lending, among banks as well as for corporate activity, and to encourage banks to get rid of all their SIV-related liabilities. The latter is, of course, in the private interests of banks too. But I think there is a chance the UK might just escape recession. Although the financial sector is such a big part of the UK economy, the direct losses are not per se in the UK. It really all depends on just how deep an abyss the US economy is really stuck in. The recent stock market gyrations are ringing ominous bells, but it remains to be seen how sustained this volatility and the downward trend will be.”