

Stock Market Turbulence

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1. The 'sudden' turmoil of international Stock Exchanges triggered by the sub-prime loans crisis is generally considered the result of several years of low interest rates and lenient lending practices. Higher liquidity has also meant abnormally low spreads in the sovereign and private bond markets with an increase in the investment preferences of institutional and private investors for more profitable and risky securities, an excessively optimistic and lax approach in the management of credit to consumers, an unprecedented access to mortgages for households also in situations where the value of the underlying guarantee was strongly affected by the (likely inflated) real estate bubble (in turn generated by the same factors) and the repayment capacity of the borrower was uncertain, due also to the increased flexibility of the labour market and the structural industrial reallocation fuelled by the globalization trend, a strong rise of highly leveraged securities transactions, especially by hedge funds and venture capital funds. These, and several other, events concurred with the emergence of innovative financial techniques (mostly derivatives) aimed at spreading the credit risk associated with these more lenient lending policies (innovation facilitated also by the universal repeal of the traditional separation between commercial and investment banking, thereby offering a much wider scope for group policies of large financial conglomerates potentially biased by conflict of interest). Sub-prime loans – such being the loans granted, usually for the purchase of a house, but sometimes also for the purchase of cars or other durable goods or as a credit facility underlying a credit card arrangement, with more limited guarantees than those required in the prime market by US governmental agencies like GNMA-Ginnie Mae, FMAE-Fannie Mae and FMAC-Freddy Mac – are a first example. Risky credits were 're-packaged' into usually complex asset-backed securities and sold to the market by the first lender which instead, normally, in the 'previous' world, would have borne the risk up to maturity and thus continuously monitored the borrower and managed the recovery of the credit. Where the securities defaulted and the final holders of such securities were investment funds, pension funds or private portfolios managed by investment companies, the shock absorber of last resort became families directly. Where the holders were hedge funds, part of the risk – the one not absorbed directly by the capital contributed by 'qualified investors' – rebounded to the banking system depending on the degree of (usually high or very high) leverage of the fund.

2. The virtues of a more complete financial setting where risks can be more widely allocated through a stronger market approach are recognized. Risk dissemination enhances, in fact, the resilience of the financial system as a whole to financial crisis. The BIS acknowledged this as early as 2003, observing that where financial markets become more complete, they increase also their robustness. Losses are more widely shared among the different segments, precisely thanks to the use of instruments for the transfer of the credit risk (such as asset-backed securities 'repackaging' sub-prime loans). According to the Bank, thus, the very fact that shocks are shared by different connected markets should facilitate their absorption. On the other hand, more recently, the same Bank warned that a drop in the real estate prices, especially if accompanied by interest rate increases, could endanger the financial system and the economy as a whole. In other words, it seems that the long-term effects of the structural re-allocation of credit risks to the market through 'innovative' financial devices (mostly derivatives) might be hardly assessable in advance and could, in the worst scenario, prove very detrimental to the level of consumption and the overall economy.

3. Once the sub-prime losses have emerged, showing, in the wake of the first failures, the signals of a possible credit crunch and risk of global contagion, both the Federal Reserve and the ECB stepped in with very substantial liquidity injections. These exceptional measures – larger in size than those following 11 September 2001 – are costly and, by nature, feeble, a monetary policy so far inspired by the strong pursuit of inflation control (and, at least in the US, of unemployment control). This has clearly been so, due to the systemic risk worries of the Central Banks, despite the encouraging data on the fundamentals of the 'real economy' and the well known aversion of Mr. Bernanke for the use of monetary policy to prevent the occurrence of *private* losses on the bursting of speculative bubbles. It could be said, thus, that the violent market's turbulences and the risk of contagion brought about by the first big failures forced the Federal Reserve out of its expected policy, preventing both Central Banks also from pursuing, in the short run, their expected policy of interest rate increases. It remains to be seen which additional measures the ECB and the Federal Reserve are ready to take in case of persistence of the crisis and if 'concerted', or at least

'mimicked and/or converging', actions shall be followed by the two Central Banks also in the near future.¹

4. In our legal perspective, the emergence of the sub-prime crisis seems to offer, from a regulatory point of view, new support for the concerns of those advocating stricter securities action and discipline both global and European. To mention only a few examples, it would appear that at least the following issues deserve some re-consideration (to be considered, though, an open catalogue).

- a) First, how to regulate and control, from a systemic and macro perspective, the issue and placement of securities, especially when they re-package credit risks and when their aggregate amount may impact on the systemic stability. Such issue must be viewed *in a global perspective* (the national provisions requiring the national supervisory authority to exercise prior control or authorize the issue or placement of such securities exceeding a significant size, where existing and not watered down in recent years, apparently fell short to avert in Europe the risk of a systemic crisis, although the source of contagion was primarily generated in the US), taking into account also the need, at the same time, that markets continue to display their useful, and probably necessary, function of wider and better dispersion and absorption of credit risks.
- b) Second, how to increase the quality of the discretionary portfolio management by all professional investors (investment funds, insurances, pension funds, investment companies or banks) by effectively improving, on the one hand, their accountability both to investors and, taking into account collective action problems and market failures, to supervisory authorities and, on the other hand, by addressing effectively the risk of conflicts of interest.
- c) Third, how to increase the transparency and the prudential control on hedge funds, without freezing, though, their beneficial activism (which is starting to exert a useful disciplinary function on the management of public listed companies)² and without eliminating or excessively curtailing their risk-taking approach in sophisticated markets.
- d) Fourth, how to ensure that rating agencies more reliably perform their signalling function and, at the occurrence of changes affecting the original evaluation of securities, provide an earlier warning (the downgrading of most ABS occurred indeed too late).
- e) Fifth, how to properly address the overarching questions of the *real* quality of credit by commercial banks and the control of excessive leverage (also to prevent as much as possible excessive concentration of risks in a single hedge fund or

other professional investor and the consequential spill-over effects) in the wake of the Basle II Accord and its new risk management principles.

5. Most, if not all, of these issues are obviously not new and are already, partly or extensively (as the case may be), addressed by European legislation and, as regards the banking industry, by the Basle II Accord and its European implementation. It remains to be seen, however (to mention only a few hot topics), at least what the results of the following will be.

- a) First, how to ensure an effective enforcement of the existing general principles *so as to avoid that they operate merely as law in the books*. It must be carefully scrutinized, for example, to what extent European fund managers complied, in the specific circumstances, with the requirement of Article 5h(a) and (b) of the UCITS Directive to act honestly and fairly, with due skill, care and diligence in the best interest of the UCITS and the integrity of the market; if the usual contractual disclaimers of responsibility in this respect can be accepted and, more in general, how to favour the most efficient reaction to possible deviations from the rule via both private and public action as well as how to ensure higher standards of loyalty and compliance and effective on-going supervision in the future.
- b) Second, how to complete existing loopholes or strengthen the relevant discipline, as it may well be the case for conflict of interest rules: an issue whose regulation and control under Article 18 of MIFID and its related level II measures seems highly insufficient. As it has been rightly noted 'recent research suggests that (mere) disclosure of conflicts of interest may not only fail to produce the intended effect, it may often have unintended perverse effects, increasing rather than reducing the inefficiencies created by conflicts of interest' since 'in most situations principals are unable to sufficiently discount the agent's actions, while the disclosure paradoxically often leads to more self-serving behaviour by the agent'.³ Based on a similar assumption the CESR advised the Commission to require not only disclosure but also client's consent; nonetheless, its recommendation, albeit initially followed, was then dropped by the Commission.
- c) Third, how to properly address the global dimension of financial risks ensuring adequate (also accounting) transparency, a more even and effective implementation of international standards (first of all, of the Basle risk management principles) and a stricter and more effective global supervision. The crisis clearly showed, indeed, that, on the one hand, the detrimental effects of lenient lending practices can

1 For some public indications, see the hearing of ECB President Trichet at the European Parliament, 11 September 2007 (available at the EP website).

2 See the special ECL issue no. 2/2007 devoted to this central subject-matter, currently examined in a regulatory perspective by both the Legal Affairs and the Economic and Monetary Affairs Committees of the European Parliament.

3 M.Kruihof, *Conflict of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate?*, in L.Thévenoz, R.Bahar (eds), *Conflicts of Interest: Corporate Governance and Financial Markets*, Kluwer Law Int., 2007, 277-335, especially at p. 326.

have spill-over effects in other areas where, in principle, commercial banking standards appear to be stricter and, on the other hand, that the failure of off-shore and highly unregulated investment vehicles, such as off-shore hedge funds, may still prompt contagion effects (almost ten years after the Federal Reserve bail-out of Long-Term Capital Management in 1998) and affect the functioning also of highly regulated in-shore markets.

6. Partly contradicting a recurrent 'adagio' according to which 'less means more' in securities and company law regulation, recent market events confirm that, obviously, better regulation is not a matter of quantity but of quality. Recent efforts to cut red tape in company law (even radical ones as those portrayed in the recent Commission's communication 'on a simplified business environment for companies in the areas of company law, accounting and auditing',⁴ triggering a much needed public consultation on the subject-matter) are, thus, certainly welcome. Equally welcome are the advances in institutional activism and corporate governance which likely prompted by the new directive on shareholders' rights became finally formal. A lot remains to be done, though, to 'complete' and fine-tune securities regulation and supervision, both at European and global levels, if we want such complex (and certainly burdensome and unfortunately costly) legal systems to really disrupt opportunistic and socially detrimental behaviour and efficiently serve the general interest as they are intended. Out of any rhetoric, it still remains valid, to me at least, that the call for action to regulators, policymakers and their legal experts expressed by the then US President Woodrow Wilson at the Annual Address of the American Bar Association of 1910: 'no matter what the exaction of modern legal business, no matter what or how great the specialization of your practice of the law, you are not the servants of special interests, the mere expert counsellors of this, that or the other group of businessmen, but the guardians of the general peace, the guides of those who seek to realize by some best accommodation the rights of men. With that purpose in view, I am asking you to look again at the corporation'.

⁴ COM(2007) 394 final of 10 July 2007. See also Ramboll Management, *Study on administrative costs of the EU Company Law Acquis*, Report commissioned by the Commission's DG Market, Internal Market and Services Directorate General, July 2007 (available on the Commission website).