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# Stock markets in the current crisis. Some remarks from the Italian experience

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An analysis of the crisis which broke out in August 2007 shows that the Italian Stock Exchange was able, by and large, to perform its essential functions through the usual operational patterns. At the same time it helps to put on the forefront some aspects which in normal market conditions are not adequately considered and to highlight its ability to register any change in economic expectations and to transmit the consequent impulses to the real sector of the economy quite rapidly.

Before outlining some of the lessons, so to say, which might be drawn from the point of view of equity markets, I would like to briefly recall some of the relevant features of the crisis:

1) its outburst took place in the credit market and was largely attributable to the primary responsibility of large international intermediaries that in their constant and obsessive quest for ever bigger profits and larger size had wholly ignored the elementary rules for sound risk management and had too hastily and too eagerly adopted the new “originate to distribute” doctrine on banking;
2) Notwithstanding difficulties, the Stock Exchange mechanism did never have to stop and continued to perform its role, typical of secondary markets, of providing all financial agents with the possibility of trading equity instruments and of punctually registering their current exchange value.
3) The behavior of the Stock Exchange was therefore in stark contrast with that of the market for both consumer and business loans, which became progressively thinner and even halted altogether at least for a certain period of time and for some types of borrowers.
4) Monetary authorities had to provide enormous amounts of liquidity, sometimes adopting wholly unprecedented techniques, to prevent financial intermediaries from stopping altogether their activity while in several countries governments had to step in with bail out operations or directly with nationalisations of banks. Equity markets, on the contrary, did not suffer from any material interruptions of trading and especially in the first phase of the crisis they were able to absorb very large amounts of sales, of blue chips in particular, and thus to provide equity holders with some of the liquidity they so urgently needed.

In my opinion, the reasons for the higher efficiency of the Stock Exchange vis à vis credit markets during the crisis can be traced back prevalently to three technical features which distinguish it from

other segments of financial intermediation and are not always fully and properly taken into account in some economic literature:

1) the availability of a significant stream of largely public information;
2) the impersonal character of trading, that reduced to manageable proportions the stigma effect which badly affected interbank markets and even influenced the flow of central bank financing;
3) the almost total absence of counterparty risk.

With reference to the first feature it is sufficient to underline that the abrupt slowdown of interbank lending and of loan markets was ultimately due to reciprocal doubts and uncertainties about the liquidity and solvency of banks, which were reinforced by lack of adequate and trustable information. Actually the crisis made evident, all of a sudden, that a vast shadow financial system had flourished side by side with the regulated one and that it had heavily impaired the stability of the former. By contrast, the large over-the-counter sector of the interbank market continued to function and even grow in relative terms because it was widely recognized and accepted and was usually based on long-standing bilateral links and on the exchange of private information.

Such doubts and uncertainties did often extend to retail customers who sometimes started old-time runs on banks that reacted by hoarding the liquidity received from central banks and consequently slowed or blocked its expected flow to the economy. This sudden bout of lack of confidence in the financial system was largely justified by the fact that it became widely evident, on the one hand, that for many assets held in the portfolios of financial institutions – not only loans but also bonds and equities - it was impossible to give a reasonable value as they were generally lacking a secondary market, whether organized or over-the-counter, and that, on the other hand, the reliability of the ratings given to many financial instruments had suffered a severe setback.

With reference to the other features mentioned above – the impersonal character of transactions in listed shares and the very low level of counterparty risk – mention should be made of the fact that trades in regulated markets are necessarily executed through a clearing house (Cassa di Compensazione e Garanzia) which makes them impersonal and at the same time takes upon itself the counterparty risk while hedging it through the collection of margins. In addition, trades in listed equities could be based on a flow of public information comparatively much more detailed and reliable than the one available on financial intermediaries, the portfolios of which, anyhow, were known to have been badly battered by the subprime crisis and its aftermath. The comparative lack of information on the situation of banks became more important because of the ensuing downgrading of the creditworthiness of the financial instruments that were issued to support the high level of leverage which was ultimately responsible for the feeding and the spreading of the bubble.

While interbank and loan markets came very close to a standstill, the ability of organized equity markets to provide listed companies with additional capital through the placing of new shares was definitely less affected. Information did play its role fully in this respect since, as is well known, the sale of new equity securities is usually linked to the current market price of outstanding shares which thus gives investors a reasonably good reference point for their decision on whether or not to subscribe the issue.

As a matter of fact, during the difficult 2008 – 2010 period number and amount of new share issues by Italian listed companies remained at levels close or slightly higher than the average for the preceding years: the amount of funds raised was comprised between 6.8 billion euro in 2010 and 18.6 billion euro in 2009 (1.7 and 4.0 per cent of market capitalisation respectively) as against an average of around 6.0 billion (1 per cent of market capitalization) in the preceding three – year

period. In other words, the decline in stock market prices did not prevent companies (and especially banks) from tapping the market as a means for reinforcing their capital structure in order to stand the consequences of the crisis.

On the other hand, as might have been expected, the price decline heavily reduced the attraction of Stock exchange listing to companies and even encouraged the beginning of a voluntary delisting trend which appears to be still under way. The subsequent downturn of the business cycle and the radical and abrupt change in investors' expectations greatly reinforced the traditional reluctance of Italian medium and small-sized companies to open their capital to outside investors. In the three-year period 2008 - 2010 only 23 companies were floated through initial public offerings were floated for a total amount slightly over 2.6 billion euro; however, the largest part of this figure (around 2.264 million) was raised in 2010 by just one company belonging to the public sector (Enel Greenpower). During the previous three-year period the i.p.o. market handled 65 operations for a total amount of 16.6 billion euro. The decline was definitely material and affected mainly large companies, thus furthering the concentration of trading on very few blue chips, a feature that contributes to the emargination of the Italian Stock Exchange from the international financial circuit.

During the crisis the superiority of organized markets became evident in comparison with over-the-counter markets in which the negotiation links directly the buyer and the seller of the securities and therefore takes place in a setting, in principle, of more opaque information and of full exposure to counterparty risk.

Such a situation explains why regulatory authorities at the international level are currently trying to favor, or to impose, that over-the-counter trades, especially derivatives, are settled through clearing houses. The success of some new trading venues – the so-called Multilateral Trading Facilities (MTF) – can be explained, not only with their satisfactory degree of self-regulation (and centralized settlement), but also because a great part of their activity involves securities already listed on an organized Stock Exchange and are consequently subject to established information requirements and disclosure rules.

The crisis also highlighted – perhaps in a much clearer way than in similar episodes of the past – that the correction of share prices after the breaking of a bubble can be sudden, unexpected and material. The consequent increase in price volatility can be attributed also to several other factors which played a specific role: easy access to trading platforms; very short time horizons on which investors and financial institutions base their decisions; the adoption of methods and techniques through which professional investors enter their orders in trading platforms speedily and/or automatically thanks to innovations (such as program trading) that may have themselves exacerbated reactions to new information and to price changes; last but not least, perverse incentives (bonuses, etc.) granted to desk traders.

Finally, I must emphasize that the wide adoption of leverage, which was undoubtedly overworked during the period of "irrational exuberance" leading to the financial crisis – permitted the build up of risk positions for a multiple of the capital actually available to investors: in such a way even a modest change in the price trend of a security or of the entire market was greatly amplified by the need for position holders to meet margin calls and to face the reduction of loans supporting their market positions.

Obviously, an increase in volatility tends to expand the risks of investment and thus to discourage potential buyers from entering the equity market. In the long run such a development is not consistent with the orderly performance of the typical functions committed to the Stock Exchange

in the economic system. As a matter of fact, after the breaking of the speculative bubble the propensity of Italian households to buy and hold equity instruments, either directly or through institutional investors, has shown a sizable downward trend: from 35.3 percent of total outstanding financial assets in 2006 to 28.9 percent in 2009 (as measured at current market prices); during the same period the share of total household financial wealth held in mutual funds contracted from 8.5 percent to 5.2 percent. In the meanwhile the holdings of currency and bank deposits and of other debt instruments increased their share of household financial assets by 3.9 and 1.6 percentage points respectively (BANCA D'ITALIA, *Relazione anno 2009,* Roma, 2010, Table 14.2, p. 167), an important evidence of a flight to liquidity.

The experience of the crisis supports the view that some of the functions that the economic theory attributes to stock exchange markets are not fulfilled properly and effectively when the assumption of rational behavior does not hold true because investment decisions are taken in an overwhelming context of emotional reactions and herd behavior and with reference to very short time horizons. For instance the attitude of Stock Exchanges to set the stage for a proper selection of listed companies and listed shares can temporarily disappear when a prolonged defined trend (either bull or bear) affirms itself in the markets, pushing in the same direction both the shares of companies showing good results and promising yields and those of companies having less than rosy perspectives. In addition, the leading position *de facto* recognized to Anglo-saxon markets as well as similar reactions of asset managers and investment banks operating in a global market, tend to shape simultaneously the performance of all the major trading venues around the world.

Such factors are likely to cause a very high positive correlation of prices in different equity markets and industrial sectors so that the principle of diversification, which is one of the most established and effective tenets of investment theory and of asset management, becomes less efficient or utterly unsatisfactory. During the crisis, however, such situations did manifest themselves only for relatively short periods of time at the end of which the critical evaluation of micro- and macroeconomic information by financial analysts and investors gradually gave back to market prices a sufficient selective power and reinstated diversification as a worthy tool for managing financial risks.

There is no doubt, for instance, that at a certain point in time the evolution of prices had the effect of penalizing the shares of companies belonging to the banking and insurance sector – *pour cause* since they were heavily affected in a direct way by the crisis and also because they are intrinsecally characterized by opaque information – to the advantage of non-financial companies and especially of those operating in sectors less exposed to the decline of domestic consumption, which was the most immediate and important consequence stemmed from the crisis when it reached the real side of the economy. In the same way a differentiation of trends in equity prices did emerge in Stock Exchanges operating in different macrogeographical areas, reflecting the fact that business companies in emerging countries were less severely hit by the economic downturn and enjoyed comparatively better earnings and growth prospects.

The above account, although somewhat sketchy, emphasizes that the interdependence between the financial crisis and the evolution of the main macroeconomic variables was manifestly very strict and that the time sequence of events was particularly rapid, possibly also because economic agents, as well as collective investors, adopted very short horizons and had made a particularly intensive use of leverage in the run up to the crisis.

The single most important factor which ultimately caused the heavy downturn of share prices following the prolonged escalation in the preceding years was, as already mentioned, the interruption of credit flows stemmed from the sudden liquidity crisis of financial intermediaries in

late 2007. The unexpected demise of a large American multi-business financial intermediary in the fall of 2008 unleashed an additional bout of uncertainty and a further decline in equity prices. It is to be noted that the large amounts of liquidity promptly provided by central banks once again in a coordinated effort were not sufficient to prevent the supply of loans from shrinking, since especially the major banks preferred to hoard such liquidity, fearing that their deep capital problems highlighted by the crisis could spur a run on their deposit base. The reduction in the supply of bank loans could obviously be justified also by the material increase in credit risk of business companies and individual borrowers when the economic downturn started to bite them severely. But such factor was not certainly predominant at the outset of the crisis.

The reduction in bank loan flows took place through the usual channels (cuts of unused lines of bank credit; reduction or outright refusal of new loan applications; calls for prompt reimbursement of outstanding loans; etc.) and had the immediate effect of reinforcing the drastic change in expectations that the fall in share prices had already transmitted to investors and to business companies. As is well known, both of them modified their behavior and their choices significantly with the result of starting the recession spiral which in its turn exerted a rather strong downward pressure on the main macroeconomic aggregates. In such a way the distress which had surfaced in a rather obscure segment of the American financial system – the now famous subprime mortgage market – not only extended itself to other distant (and more important) areas of the global financial system, but found an outlet into a deep crisis of the real economy of the major industrial countries, with the ensuing disruptive chain reactions on the behavior and the stability of all economic agents, including governments.

The creation of very easy liquidity conditions and particularly the decision to reduce official interest rates down to an unprecedented low level and to keep them very low for an indefinitely long future were not sufficient to set in motion again bank lending to the economy. In stark contrast with popular belief, no immediate reaction came from share prices, which are usually considered sensitive and resilient to the trend of interest rates. Such an upturn can presumably take place, as historical experience also tends to show, when a new change in general economic expectations will emerge and possibly only after significant steps will have been taken to restore the robustness and the reputation of the banking system through measures aimed at coping with the heavy stream of bad loans and loan losses which is the usual lasting effect of every cyclical downturn of some importance. Low interest rates do of course benefit business companies, especially large ones having an inadequate capital structure, but at the same time they damage the profitability of the banks themselves thus making both the absorption of loan losses and funding on the equity market more difficult,

Mention should be made here also of the fact that a certain amount of loans had been granted with the purpose of providing the main shareholders of some important listed companies with the funds they needed to keep control of their own company or of affiliates and had been backed by the pledge of an equivalent amount of listed shares. Since their market prices have not returned to the levels taken into account at the time of the pledge, the banks involved are now practically constrained to face the hard dilemma of keeping (and/or increasing) such loans in their books (with their implicit losses) or of liquidating the pledged shares with the risk of undermining badly the financial and governance structure of their customers. Information surfaced in the financial press leaves no doubt that the banks involved tend to prefer the first choice, which results in lengthening the period of time in which they will hopefully try to avoid (or simply to dilute) the losses connected with such loans.

I should conclude that the role and the responsibilities of the Stock exchange in the crisis were rather modest. The Stock Exchange, I believe, did not determine, but only followed, the course of events. In this respect it did play fully its role of transmitting clearly and promptly, every signal of change in expectations to investors and to the other agents of the economic and financial process. This rather peripheral position can probably explain, why in the aftermath of the crisis the most important issues and consequent calls for changes in legislation and regulatory practices were addressed to financial intermediaries rather than to equity markets. As is well known, international bodies and domestic regulators are currently trying to impose on them higher capital requirements - aimed at setting limits to their search for size and to their appetite for risk – as well as to prescribe stricter disclosure rules and to enforce a more rigorous compliance with basic risk management principles, especially in the field of liquidity and of adequacy of organizational structures.

Securities markets, of course, are not completely exempt from the criticism and from the regulatory attention following the crisis. In their case, however, present regulatory efforts seem to be guided by the opinion, which has become more largely accepted, that their degree of efficiency and their supposedly perfect functionment had been overstated both in theoretical writings and in current public policy debates as well as in prevailing supervisory attitudes in some countries. In addition, present discussions emphasize the fact that the operation and structures of equity markets were relying too heavily on, or were giving too much importance to, the principle of self-regulation which, however, did not reveal itself strong enough to resist the attraction of easy and large profits that its violations might reap for financial intermediaries, investors and trading venues.

The changes that authorities will seemingly try to pursue, are directed, on the one hand, at making transactions more secure, by enhancing pre-trade and post-trade transparency and by trying to impose the settlement of over-the-counter trades through clearing houses. On the other hand, they appear to be willing to foster the improvement of the quality of market and corporate information, rather than insisting on more detailed information, and to react to violations of disclosure requirements and to market abuses with more timely and stronger enforcement interventions.

It appears to be quite difficult, both from a theoretical and practical point of view, that supervisory authorities and policy makers succeed in coping with long-seated psychological attitudes towards risk-taking and with the largely irrational behavior of investors. In fact they tended to react to changes in securities prices with orders originated in an impulsive way and a short time frame, or based mainly on imitation, suggestions or investment tips of extemporaneous consultants rather than on sound company and market information. In such a way they reinforced market trends and made it easier for speculative-minded investors to realize their short- term trading schemes.

I strongly doubt that individual investors, in Italy and elsewhere, will duly take account of this important "lesson" of the crisis. At best it may produce just a minor dissuasion effect which will possibly last only until the next bubble will start to inflate again.

It is to be hoped that the crisis has definitely convinced collective investors – many of which were badly hit by the stockmarket downturn – and bank executives in charge of asset management services to comply strictly and firmly to investment schemes rationally based on truly independent long- term fundamental analysis and on risk/return objectives, to be set at levels both reasonable and consistent with their institutional functions.

In my opinion, nonetheless, a check on excessive leverage is to be encouraged both with reference to *stricto sensu* individual positions in equity markets and to the financing of major shareholders of business companies. Although far from being a decisive factor, it would certainly contribute to slow down the build up of bubbles and to moderate the ensuing increase of the instability risk for both

the financial system and the real economy. From my particular perspective the efforts which are currently displayed by international and domestic regulatory authorities in spurring a higher capital base for banks, if succesful, will very likely benefit also equity markets by indirectly reducing their historical and intrinsic instability.

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