

US

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strong medicine required to calm nerves
and start to rebuild confidence.

Strong medicine required

It is difficult to describe the past few months without using vivid terms. We are experiencing a worldwide financial panic that was spawned in the US sub-prime mortgage-backed securities market and spread due to a lack of market confidence in the valuation of those, and subsequently other, residential mortgage-backed securities, structured securities and collateralised debt obligations. This problem has been exacerbated by the proliferation of investments in structured instruments that were not fully understood by some of the investors and by the implementation of mark to market (fair value) accounting (FAS 157), which treats paper losses as though they were real losses.

The financial supervisors in the Treasury and the Federal Reserve have, until recently, underestimated the severity of this problem and have treated it with minimal ad hoc remedies that either did little to relieve or exacerbated the fear and uncertainty in the capital markets. The freeing-up of credit markets because of this fear has put downward pressure on asset prices, particularly housing-related assets, which has in turn increased actual losses. The Treasury and the Fed have to calm the markets and give them time to heal and give investors time to regain confidence. There is no magic fix for these problems. Given the severity of the lack of confidence and the time over which it has developed (more than a year), it is likely that this will not happen overnight and will not happen at all as long as the Treasury and the Fed keep changing their assessment of the nature and severity of the problem. They are also carrying the additional burden of their own impaired credibility.

Regardless of the short-term solution, these events are likely to lead to the re-regulation of financial markets and financial institutions. This re-regulation will be fuelled by populist sentiments that persist in the US today and are reminiscent of elements of the agrarian reform movements of past decades. Hopefully, the Troubled Assets Relief Programme initiatives announced in recent weeks will provide the US capital markets with the