

FIXING FINANCE

HOW TO PREVENT A RECURRENCE OF THE
GLOBAL ECONOMIC CRISIS



Sponsored by



ALVAREZ & MARSAL



ALVAREZ & MARSAL

 breakingviews.com

Contents

Preface	1
Key recommendations	3
Diagnosis	4
Chapter 1 – Stopping bubbles	8
Chapter 2 – Small is beautiful.....	16
Chapter 3 – Rebalancing the globe	26
Chapter 4 – Controlling the casino	36
Chapter 5 – Heads I win, tails I win	51
Chapter 6 – Battling incompetence	58
Chapter 7 – Don't regulate everything.....	65
Chapter 8 – Personal views.....	75
Epilogue	83
Further reading	84
About us	85
About Alvarez & Marsal	86

Preface

Fixing finance

The financial crisis has made a mess of the global economy. Unemployment is soaring across the globe, trillions of dollars of wealth have been destroyed and taxpayers will have to spend many years repaying the mountains of debt governments have incurred to fight the crisis. The world needs to make sure that a crisis this bad does not recur.

But what exactly should be done? April's G20 summit in London has already set out the broad outlines of a new regulatory blue print. In a nutshell, the authorities are determined to prick bubbles before they get too big, stop banks taking excessive risks and make sure they have bigger buffers so they are better able to weather the next storm.

While Breakingviews.com agrees with this framework, we also think the debate needs to be pushed forward in four main areas.

First, so-called global imbalances need to be tackled. So long as countries like the US and the UK – but also some emerging markets – run massive trade deficits financed by short-term borrowing, the world will be vulnerable to crises.

Second, the world needs to be made safe from banks that are too big to fail. If financial institutions are cut down to size – or mechanisms are put in place that will allow them to go bust in a way that doesn't cause havoc – everybody else can relax.

Third, more needs to be done to stop the build up of excessive debt by companies and individuals. It is particularly barmy to incentivise people with tax breaks to take on debt.

Finally, everybody operating in the markets needs to become more competent. Investors should do their own homework. Bankers should study financial history before they qualify. Directors should endure an inquisition to check they are up to the job. And regulators should be paid more so they aren't always outfoxed by the banks.

This collection of articles, written over the past few months, sets out proposals on these and related matters. We also have a chapter on regulations that we don't want to see – as well as a couple of provocative personal views which are not yet house views. We hope this book will inform an extremely important global debate.

Many thanks to Constantine Courcoulas who helped research this book and worked on its production. Many thanks to Alvarez & Marsal, who have sponsored this edition.

Hugo Dixon,
Editor-in-Chief
Breakingviews.com

June 2009

Key recommendations

- Require banks to stash away provisions in good times
- Eliminate tax deductibility of corporate interest but cut corporate tax rates
- Central banks should charge upfront for acting as lenders of last resort
- Impose stricter loan-to-value ratios for mortgages
- Regulate giant financial institutions more tightly than smaller ones
- Set up a global bankruptcy regime to allow giant banks to fail safely
- Governments with trade deficits should run budget surpluses
- Banks that finance forex carry trades should hold more capital
- Encourage long-term pricing in commodity markets
- Regulate hedge funds' access to leverage via their prime brokers
- Don't push up base salaries just because bonus has become a dirty word
- Pay regulators more
- Require bankers to study financial history
- Regulators should grill bank bosses to ensure they're up to the job
- Don't bring in a new "Glass-Steagall" Act
- Don't ban short-selling
- Don't fiddle with mark-to-market accounting

Diagnosis

Skewed finance

To prevent a relapse, first understand the disease. Some have been fast to blame the meltdown on capitalism. That's wrong. Free markets and free trade are not to blame for the current woes. The real culprit is skewed finance. The distortions operated on five levels.

First, there has been an imbalance in world trade, with giant surpluses in China matched by deficits in the US and UK. That allowed borrowers to rack up huge debts. It wasn't a natural phenomenon of the free market. It was at least partly the result of China's decision to keep the renminbi's value artificially low.

Second, there was the US habit of bailing out the financial system with cheap interest rates whenever it hit trouble. Investors used to talk about the "Greenspan put", in recognition of the fact that the former chairman of the US Federal Reserve could always be relied upon to squirt money on the markets at the first sign of trouble. This, again, distorted the free market. It both numbed investors' fear, causing them to take excessive risks, and added cheap credit in the West to the liquidity pouring in from the East.

Third, governments subsidised the build-up of debt. In most countries, corporate interest payments are tax deductible. In some countries, such as the US, mortgage interest payments are also tax deductible. That provided an incentive for companies and individuals to leverage themselves up to the gills. Again this was a distortion of the free market.

Fourth, there was the inherent distortion in having financial institutions that are considered "too big to fail". Banks were almost encouraged to sail too close to the wind. If all went well,

the profits were huge. If not, the authorities could almost always be relied upon to bail them out. The antidote to having institutions that are “too big to fail” is either to cut them down to size so they can fail safely or to regulate them more tightly. But, in recent years, banks got bigger and were deregulated.

Finally, there were the “heads-I-win-tails-you-lose” incentive plans for the financiers themselves. If their bets paid off, they stood to become multi-millionaires. If they lost a packet, shareholders and ultimately taxpayers were left to pick up the tab. Some culprits have even been able to walk away with fat bonuses and enhanced pensions. This, again, is not the free market. It is an asymmetry that turned finance into a casino.

Inadequate regulation

There are two ways to deal with such huge distortions in the financial markets: root them out or regulate the financial system adequately. The authorities did neither. For three decades, the zeitgeist – triggered by the Thatcher/Reagan revolution and then presided over by Greenspan during his long reign at the Fed – favoured deregulation, light-touch regulation and laissez-faire.

A full catalogue of regulatory failure would take volumes. But there were three big problems. First, the authorities stood idly by as the explosion of credit fuelled the boom. Many believed the Greenspan doctrine that it was too hard to spot bubbles and better to mop up the mess after they had burst.

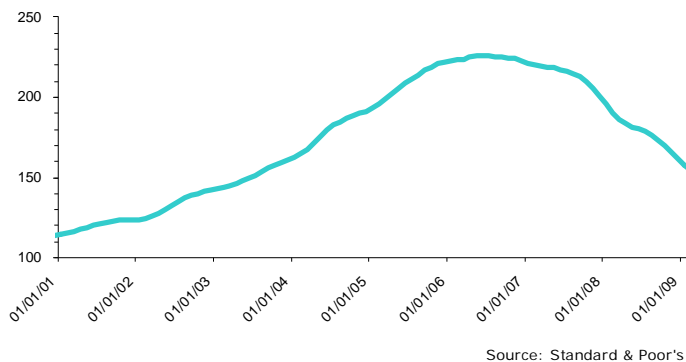
Second, the capital and liquidity buffers banks were required to hold as cushions against disaster were not big enough. On the contrary, the regulatory regime actually encouraged banks to increase their risks as the economy grew faster. Such “procyclicality” is crazy.

Third, there was incompetence at pretty much every level. Investors contracted out their brains to ratings agencies. Most

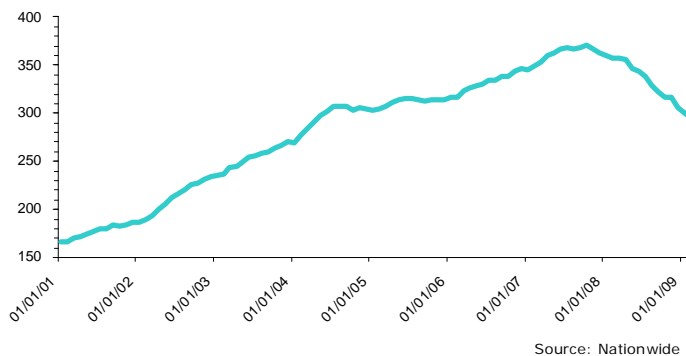
bankers were young and lacked enough historical perspective to realise that bubbles have a habit of bursting. Banks had non-executive directors who didn’t understand complex new products and were unable to hold executives to account. And regulators weren’t sharp enough, not least because banks typically poached the bright sparks with offers of financial rewards beyond the dreams of civil servants.

The proposals contained in this book work on two main levels. They seek to strengthen both the discipline of the market by reducing some of the distortions in the financial world and the discipline provided by regulators. After the chaos of the last two years, such a belt and braces approach is needed.

S&P Case-Shiller house price index
Jan 2001 - Feb 2009



Nationwide UK house price index
Jan 2001 - Feb 2009



Chapter 1

Stopping bubbles

If you could stop bubbles inflating in the first place, you wouldn't need to deal with the mess that comes when they burst.

When Alan Greenspan ran the US Federal Reserve, he didn't believe you could reliably spot bubbles. He preferred to mop up the debris after they popped.

The latest crisis has shown that this laissez-faire attitude is extremely dangerous. Policy-makers are now focusing on how to prevent credit booms getting out of control. In the jargon of policy wonks, "macroprudential" regulation is all the rage.

What tools can be used to stop credit growing too rapidly? The favoured one is to jack up banks' minimum capital ratios when the party is getting too heated – and lower them when a crisis hits. We think such a "counter-cyclical" capital regime is a good idea. But it needs to be managed carefully. Otherwise capital ratios might just ratchet upwards – rising in good times but never dropping in bad times.

We also think that other tools are needed to stop bubbles. We are keen on three:

Banning banks from lending more than, say, 80% of the value of people's homes. That would help prevent housing bubbles, a big feature of the crisis.

Charging banks for the potential support from authorities prepared to act as lenders of last resort. The banks would then be less keen to push up their own lending.

Removing tax relief for interest expense. This would reduce the incentives for companies to leverage themselves up.

Ratcheting through the cycle

By Hugo Dixon

How can future bubbles be prevented? One way is to jack up bank capital in boom times, in order to stop excessive credit growth. The G20 summit in London has just signed up to the idea. In principle, what policy wonks call a “countercyclical” capital regime is an excellent idea. It would not only prevent booms getting out of hand; capital requirements could be lowered when hard times return, cushioning the bust.

The snag is that it could be a lot easier for the authorities to push up minimum capital ratios in a boom than lower them in a crisis. Indeed, in recent months, regulators have said they are happy for banks to eat through their capital cushions – but the market hasn’t paid a blind bit of notice to them. Investors look at banks and think: this is a crisis; you need more capital to deal with it.

Imagine regulators set a minimum core Tier 1 capital ratio of, say, 4% but increased it to 7% during an economic boom. When the next bust came along, investors might not want the ratio to fall below 7%. A countercyclical capital regime therefore risks becoming a ratchet – dampening the upswing but accentuating the downswing. That would be unfortunate.

This is not, however, a reason to give up on the idea. It just needs careful design. A better approach would be to set a minimum capital ratio throughout the cycle – but tell banks in the good times to stash away provisions against future losses. They would build up piggy banks explicitly meant to be emptied on a rainy day. In some ways, such an idea would amount to going back to the future. In the old days, banks used to keep hidden reserves on their balance sheets, to be used up when actual losses mounted. In a new world, though, the size of such piggy banks should be completely transparent,

The difference between a rainy day fund and variable capital ratios is still purely presentational. If markets were totally efficient, both methods would lead to the same result. But everybody knows now that markets are inefficient. Good presentation of a countercyclical capital regime will be the key to its success.

April 6 2009

Hot money tax

By Hugo Dixon

During the crisis, many banks couldn’t finance themselves in the markets. So they turned to central banks for desperately needed liquidity. The role as lender of last resort is a perfectly reasonable one for central banks. But it shouldn’t be given away. Banks should pay upfront for the possibility of using it.

Walter Bagehot, the 19th century economist, said that in a crisis central banks should lend freely but at penal rates. Unfortunately, only half of this dictum was followed during the crisis. In most cases, the authorities decided that the afflicted banks were in such dire straits that penal rates were unaffordable.

That judgement may have been right in mid-crisis. There is, though, an alternative way of making banks pay for their liquidity support, while also discouraging them from relying too much on hot money in the first place. Central banks should charge banks fees for the right to access the lender of last resort facility in a crisis. Just as healthy companies pay fees to keep access to lines of credit, cash-rich banks would purchase a sort of insurance policy against a liquidity squeeze.

What’s more, the more reliant banks are on hot money, the higher the fees should be. So, for example, a bank which

funded itself largely through deposits would pay a much lower fee than one which relied totally on the easy-come-easy-go money markets.

If the fee was calibrated in the right way, that would give banks an incentive to build up deposit bases, which tend to be a more stable source of funding. It should also be less economically attractive for banks to engage in the risky practice of borrowing short-term hot money and investing it in long-term illiquid assets.

Central banks could also conceivably vary such fees during the cycle. If they felt that credit was growing too fast, they could jack up the payments. That could be a useful extra tool to stop bubbles emerging.

A final advantage of such a charge is that the authorities would amass piggy banks in the good times. These could go some way towards offsetting the losses taxpayers will incur to mop up the mess when the next bubble bursts.

May 20 2009

Not just mortgages

By Hugo Dixon

Encouraging companies to gear up is barmy. Yet, that's the effect of allowing interest payments to be deducted from profits before tax bills are calculated. The tax advantage makes borrowing more tempting for companies. That allure has helped bring the world to the brink of crises in leveraged buyouts and commercial real estate. Many companies will go bust and banks will suffer bigger losses – making the recession deeper than it needed to be.

The tax deductibility of corporate interest costs is a long-standing tradition in most countries. In the US, it was part of the first taxes on profits, in 1894. The spurious justification is that interest is a business expense like any other. But it is better to consider all debt as a type of capital, like equity. The difference is that the payments made by companies to service their debt are tax deductible – whereas dividends generally are not.

Companies, therefore, have an incentive to pile on debt and reduce their equity. They are only restrained by the fear that when business turns down, the money won't be there to make interest payments.

In the boom those fears melted away and the cult of “financial efficiency” took hold. The tax deductibility only added to the appeal of low interest rates. There was super-high leverage in two areas - LBOs and commercial real estate - while some ordinary companies levered up by borrowing to buy back shares. Then there were debt-financed acquisition sprees.

All this taxpayer-financed speculation helped create bubbles which have now burst. Losses on corporate and commercial real estate loans originated by US financial institutions alone will reach \$829bn in this cycle, according to RGE Monitor, a research firm. To this should be added mark-to-market losses on corporate debt and commercial real estate securities, which were \$745bn in December.

Some countries such as Germany have reduced tax advantages for highly leveraged companies. The current crisis offers an opportunity for more general reform. Governments should phase out the tax-deductibility of interest payments, so that taxes are paid on operating profits. To make the effect on businesses as a whole neutral, corporate tax rates should be cut.

Of course, in a world without tax subsidies for debt, LBOs and highly leveraged organisations will pay more tax. The private

equity industry would howl in protest at the prospect. They should be ignored.

It may be possible to get an international consensus. The zeitgeist is changing. G20 countries have already come together to crack down on tax havens. Why not try to do the same for debt-driven financial engineering?

April 7 2009

Steady on

By Edward Hadas

There's a simple solution to housing bubbles. Ban banks from lending people more than, say, 80% of the value of their homes. And if house prices start rising too rapidly, cut the maximum loan-to-value ratio – say to 70%. Such a prescription is rightly being considered by the G20 in response to the current crisis.

A family's home should be more of castle than a financial speculation. But when mortgages were too freely available, housing became a sort of long-only hedge fund for ordinary people. In countries such as the US, UK and Spain, the strategy was simple: a little money, a lot of leverage and hope that prices rise. The higher the loan-to-value ratio, the greater the gains.

Both borrowers and lenders have shown that they need help to restrain their speculative instincts. Bubbles cause too much pain to be tolerated.

How should the authorities proceed? The greatest challenge isn't actually technical. It's emotional. Central bankers and politicians need to respond with visceral revulsion to excessively rapid house price increases. Otherwise, any regulations will be circumvented as soon as the next supposed new era arrives.

But once the will is there, capping loan-to-value ratios is a good starting point. If buyers have to put down 20% or more of the purchase price, they will find it harder to pay over the odds for homes. That will help stop the bubble inflating. What's more, with so much skin in the game, they will be less likely to walk away when times get tough.

Regulators in some jurisdictions, including Hong Kong, the Netherlands and Singapore, already have set formal maximum

LTVs of 65-85%. It has helped keep prices down in some countries. In others, regulators were too ready to wink at cheating.

Countries should go beyond setting maximum LTV ratios – and enforcing them rigorously. They should also lower LTV ratios whenever house prices start rising too fast for comfort. How fast is too fast? That would be a judgement call. But as long as regulators consider house price inflation an almost unspeakable evil, their judgements are likely to be sound.

March 31 2009

Chapter 2

Small is beautiful

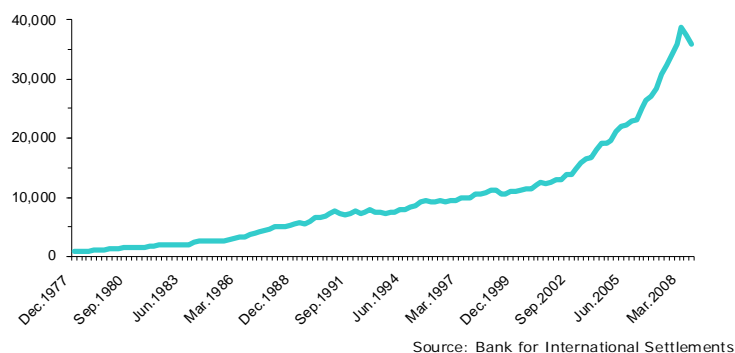
Big financial institutions are big trouble. If they collapse, they cause mayhem – dragging down other banks and ultimately the whole economy. If they are rescued, taxpayers have to fork out billions. What's more, the knowledge that they are going to be rescued means that they will be willing to take big risks. If the risky bets pay off, the bankers get rich. If not, you know who picks up the tab.

The financial crisis has made the problem of gigantism even worse. That's because weak institutions – Bear Stearns, the dregs of Lehman Brothers, Merrill Lynch, HBOS and Fortis – have been thrust into the hands of supposedly stronger rivals. The big have got even bigger, and sometimes weaker.

There are partial solutions to the “too big to fail” problem. One is to “tax” the biggest banks, by requiring them to hold more capital and more liquid assets. The US is pioneering this idea – and, at time of writing, it looks like the UK was on the point of copying. This is a very promising concept. A well designed arrangement could both stop big banks from failing and give them an incentive to get smaller.

Another idea is to develop “resolution” schemes to let banks fail safely. In other words, to collapse without causing too much collateral damage. Again, the US is pushing the idea. But for this to work well, international collaboration is needed. That's hard to get – but, given how much pain the crisis is causing, it shouldn't be impossible.

Total bank liabilities
BIS reporting banks, billions \$



Big is ugly

By Hugo Dixon

Small Is Beautiful. That was the title of a book by E.F. Schumacher which argued that vast organisations were bad for humanity. The current crisis shows the wisdom of the economist's slogan. The bailout at Citigroup shows just how ugly big can be.

After Bear Stearns and, then, Lehman Brothers went down, it became fashionable to argue that investment banks are safer if they are part of larger institutions. This is nonsense. Bigger banks are just even more frightening, which makes them too big to fail. As Iceland recently discovered, that implicit safety can become dangerous when institutions become too big to save.

Citi's tailspin wasn't required to show that pure investment banks weren't the only ones that got into trouble. Remember UBS, Wachovia, RBS, HBOS and Fortis? None was a pure investment bank, but all suffered huge losses from dabbling in risky assets. Their other businesses did little to cushion the blow. Indeed, the mix of businesses may have made these banks less competent in managing trading operations – or even more reckless.

Unfortunately, the crisis is creating even bigger financial conglomerates. Bank of America has gobbled up Merrill Lynch; Barclays and Nomura have feasted on Lehman's carcass; JPMorgan has snapped up Bear and Washington Mutual. Unless something is done in the meantime, the next crisis will strike even more behemoths that are too gigantic to fail.

This recent conglomeration is, to some extent, unavoidable. But it is not desirable. The real way to make banks safer is not to make them bigger but make them take smaller risks. And the real way to make the world safer is to cut banks down to size so none is too big to fail.

November 24 2008

Taming giants

By Hugo Dixon

Tim Geithner has come up with a bold idea: a “too big to fail” tax. Other countries should consider copying the US Treasury secretary’s lead.

In the old days, bank regulators used to think that bigger was safer – and gave larger institutions more leeway. But the current crisis has rammed home a different point: the bigger and more intertwined an institution, the more havoc it causes when it gets into trouble. Either it gets bailed out like American International Group, Citigroup, Royal Bank of Scotland or UBS, at huge cost to the taxpayer. Or it goes bust, like Lehman Brothers, and scatters debris over the entire financial system.

Geithner’s solution is to regulate giant and complex financial institutions more tightly than smaller, simpler ones. Provided his proposals are adopted by Congress, such institutions will need more capital, more liquid assets and tighter risk management.

There are two advantages in this scheme. First, more stringent regulation should make it less likely that such institutions sail close to the wind. Second, this regime – especially the stronger capital and liquidity requirements – will be expensive for the institutions concerned. Unless there really are economies of scale in staying big, such behemoths could find it economically attractive to break themselves into smaller pieces. Once fragmented, society would no longer need to worry too much if the components failed.

Geithner hasn’t spelled out which institutions would be covered. But it would be surprising if it didn’t cover the big boys: Bank of America, Citigroup, Goldman Sachs, JPMorgan, Morgan Stanley and Wells Fargo. A few nonbanks such as AIG, Fannie Mae, Freddie Mac and GE Capital might well make the list.

This is pretty ironic. Three of these banks – BofA, JPMorgan and Wells Fargo – have bulked up in the crisis by buying troubled peers (Merrill Lynch, Bear Stearns and Washington Mutual, and Wachovia

respectively). What’s more, this has been at the behest of the government. So expect protestations about how unfair life is as Geithner tries to push his plan through.

Expect similar complaints if other countries follow the US lead. Two of the prime candidates in the UK for a too big to fail tax would be Barclays and Lloyds. The former swallowed Lehman’s US business; the latter gulped down HBOS. Meanwhile, in France, the top bank is BNP Paribas, which has just feasted on much of Fortis, the near bankrupt Benelux group. And, in Germany, Commerzbank has swallowed Dresdner Bank. Penalising such banks with tougher regulations will not be popular with their bosses or shareholders. But that’s not a reason for backing off.

Context news: Tim Geithner said systemically important financial institutions should more tightly regulated than other firms. He also called for a new “systemic” regulator. Speaking to the House Financial Services Committee on Thursday, the US Treasury secretary said:

“Capital requirements for these firms must be sufficiently robust to be effective farther into the tails of potential outcomes than capital requirements for other financial firms. And they must be less pro-cyclical, requiring firms to build up substantial capital buffers in good economic times so that they can avoid deleveraging in cyclical downturns.

“The single systemic regulator will also need to impose liquidity, counterparty, and credit risk management requirements that are more stringent than for other financial firms. For instance, supervisors should apply more demanding liquidity constraints; and require that these firms are able to aggregate counterparty risk exposures on an enterprise basis within a matter of hours”.

Geithner said that the characteristics for identifying systemically important firms should include “the financial system’s interdependence with the firm, the firm’s size, leverage (including off-balance sheet exposures), and degree of reliance on short-term funding, and the importance of the firm as a source of credit for

households, businesses, and governments and as a source of liquidity for the financial system”.

March 27 2009

Resolution time

By Hugo Dixon

If only financial giants could be allowed to fail in a safe way. Lehman Brothers could have gone bust without the global financial system suffering a cardiac arrest; the likes of AIG and Citigroup wouldn't have needed to be propped up with tens of billions of taxpayers' money.

But is this just a pipedream? Tim Geithner last week gave the impression that it was not – if only the US had the necessary powers to seize financial institutions that are teetering on the brink. The Treasury secretary then promptly asked Congress for such powers to cover all systemically important institutions including bank and brokerage holding companies as well as insurers. At present, the authorities can only seize control of ordinary banks and thrifts, such as Washington Mutual, and government-sponsored agencies, such as Fannie Mae.

The key new power that Geithner wants is to be able to appoint a trustee who can renegotiate or repudiate an institution's contracts without the approval of creditors or other stakeholders. The trustee could theoretically deliver haircuts of whatever size it deemed appropriate to shareholders, bondholders, employees, derivative counterparties and the like.

Geithner's plan would certainly help “resolve” such messes. But it isn't a miracle cure. Some financial institutions, such as AIG, Lehman or Citigroup, are so complex and global that they couldn't just be allowed to fail even if the US government had these new powers.

The contrasting examples of WaMu and Fannie Mae illustrate the advantages and limitations of the approach. The former was seized last year by the Federal Deposit Insurance Corporation. The company's shareholders, including TPG, were wiped out, while its subordinated bondholders will probably end up with a buzzcut. Its branches and most of its assets were packed off to JPMorgan at no cost to the taxpayer and no damage to depositors. This was a satisfactory outcome in that pain was inflicted on those who merited it most. It worked because WaMu was a relatively simple domestic business.

Meanwhile, Fannie Mae – and its sister Freddie Mac - has been in “conservatorship” since the week before Lehman went bust. Their ordinary and preferred shareholders have been left to hang. But the government guaranteed \$5.4 trillion of the mortgage giants' debt. It felt mayhem would have occurred if these creditors, among the biggest of which was the Chinese government, had been forced to take losses. As a result, taxpayers look like they will get landed with a huge bill.

The Fannie example shows that, even if the authorities have the power to impose haircuts, it's not necessarily safe to go for a short back and sides. With AIG and Lehman, counterparties could probably have taken a trim. But panic could still have spread around the financial system if the haircuts had been too severe. So the authorities have to be careful not to plunge the scissors accidentally into the counterparties' brains.

AIG and Lehman – let alone Citi - would have been even more complex than Fannie because of their global operations. Foreign countries would not take kindly to any attempt by Washington to repudiate non-US contracts. So, for Geithner's scheme to work for global giants, there will have to be some form of international collaboration. At least some jurisdictions, such as the UK, have powers similar to the ones Geithner is now seeking. So it might be possible for different countries to agree on how they would share the burden in the event that a multinational bank needed resolution.

A year ago such cooperation would have been unthinkable. The Lehman bankruptcy, for example, triggered a dispute between the

US and UK over whether \$8bn in cash should have been removed from the British subsidiary and sent to New York just before the broker went bust. But the current crisis has shaken people up so much that things which used to be in the too-difficult box may now just be possible.

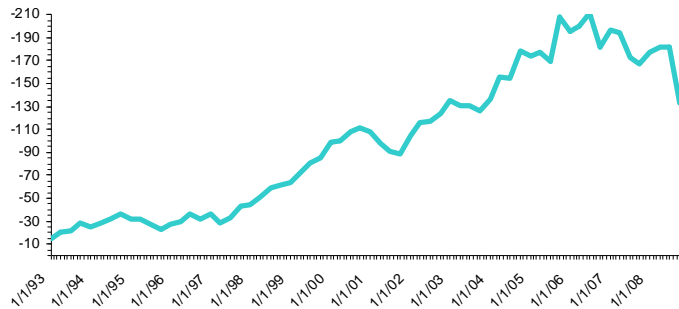
Context news: Tim Geithner has asked Congress for the power to seize systemically important financial institutions that are in danger of going bust. The US Treasury secretary last week proposed new legislation that would allow the administration to put such institutions into conservatorship or receivership – during which they would either be nursed to recovery or wound down in an orderly fashion.

The trustee of such conservatorship or receivership would have broad powers – including the ability to renegotiate or repudiate an institution's contracts without the approval of creditors or other stakeholders.

The proposed legislation is supposed to fill a gap. The Federal Deposit Insurance Corporation has similar powers with respect to banks. So does the Federal Housing Finance Agency with respect to government-sponsored enterprises such as Fannie Mae. The new legislation would cover bank holding companies, holding companies that control broker-dealers, insurance companies and other systemically important institutions.

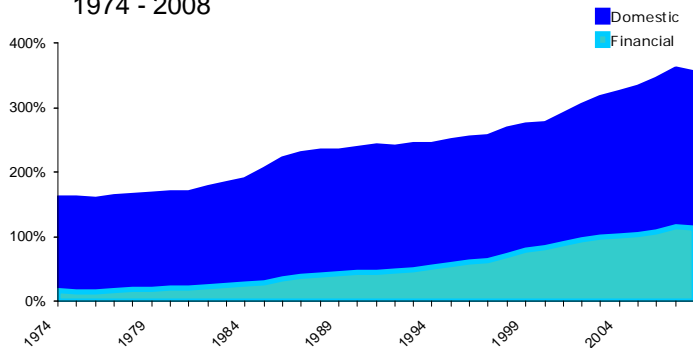
March 30 2009

US current account deficit
Jan 1993 - March 2009, billions \$



Source: US Federal Reserve

US debt outstanding as percentage of GDP
1974 - 2008



Source: US Federal Reserve

Chapter 3

Rebalancing the globe

A glut of savings, in China and elsewhere, helped finance loose spending and lending in the West. Fixing this imbalance in global finance is a priority. Ideally, the US and other countries such as the UK need to live within their means – and big net exporters such as China need to consume more goods.

Policymakers in the West have been jabbering about this for years, but without much success. After all, it takes two to tango. There may, though, be ways to mitigate the problem. One would be for the US to run a budgetary surplus. Another would be to try to borrow money in dollars from the Chinese for very long periods of time. That would slow down the pace at which Beijing could withdraw its dollars from the US.

Mind you, China may not like the idea. Its own scheme is for a new global currency to replace the dollar. It's a nice proposal - in theory.

At least the US gets to borrow in its own currency. Many other debtors, such as homeowners and companies in Eastern Europe's stricken economies, have borrowed in hard foreign currencies. When times were good, hot money flooded in. But when times turned tough, their own currencies tanked and their debts ballooned. This pernicious practice of borrowing in foreign currencies needs to be stamped out.

Many emerging economies have also been whipsawed by the commodities roller-coaster. When the oil price went through the roof, the likes of Russia thought themselves rich as Croesus. When it tumbled, they were plunged into recession. The dizzy ride of commodity prices is driven by speculation. It isn't good for producers or consumers. It too needs to be dampened.

Rebalancing act

By Hugo Dixon

Cheap money from China helped create the bubble that has now burst spectacularly. Beijing's policy of keeping its currency artificially low allowed it to rack up massive trade surpluses - cash which was recycled to help Americans live beyond their means.

Given this, one might have thought the G20 leaders gathering in London would be focusing on preventing such imbalances in the future. In fact, it looks like they are going to shirk the issue. That's largely because confronting it would cause a diplomatic row. After Tim Geithner, the US Treasury Secretary, suggested the Chinese were manipulating their currency in January, Beijing accused the Americans of lax regulation and excessive consumption.

The G20's draft communiqué pussy-foots around the topic, merely committing the countries to get the IMF to conduct "candid" surveillance of their economies and the impact of their policies on each other.

Optimists may hope that Beijing has learned its lesson. China's exports have slumped as US and other debtor nations have tightened their belts. But don't count on it. Candid surveillance should therefore be supplemented by two other items of self-help - once the immediate crisis is over.

First, so long as the US continues to run a trade deficit, it should run a government budget surplus. That should mitigate any renewed attempt by Americans to live beyond their means. And, if and when another crisis hits, at least the government's finances will be in better shape.

Second, again after the immediate crisis is over, the US should try to refinance its existing debt by selling the Chinese

extremely long-dated dollar bonds. If it could lock in cheap funding in its own currency, it would no longer have to fear that Beijing might pull the rug out from under it.

The Chinese, of course, may not go for this. The governor of the Bank of China has, after all, already started talking about the need for a new global reserve currency. But Beijing cannot have it both ways. If it really promotes an alternative currency, the dollar will sink - which, in turn, will help rebalance world trade.

April 1 2009

Paper into gold

By John Foley

The world outgrew the gold standard decades ago. But a "paper gold" standard might be one way out of the global financial crisis. Zhou Xiaochuan, governor of China's central bank, has proposed shifting the world from its dependence on the US dollar to a new reserve currency managed by the International Monetary Fund. The idea is good - if only China meant it.

The greenback has been the world's dominant reserve currency - equivalent to a financial lingua franca - since the end of the Second World War. Countries hold it in spades to back their own currency. The IMF reckons that two-thirds of the \$6.9 trillion of foreign currency holdings worldwide are in US dollars. The euro, the second most-held currency, makes up just a quarter.

Were international trade switched instead to an IMF-managed currency - Zhou suggests a little-used device called a "special drawing right" or SDR - Uncle Sam would have a real headache. America's borrowing and trading costs would spike.

After all, the US saves by rarely needing to convert its own money – a perk known as “seigniorage”.

But in the long term, the US would benefit. Being the currency of choice has made it unnaturally cheap for the US to borrow and fund its consumers’ profligate habits. Besides, as Zhou points out in a scholarly flourish, there’s the Triffin Paradox to consider. This says that so long as the US agrees to feed the world with dollars, it can’t successfully control its own currency.

Having a central currency – let’s call it the Zhou-Triffin Doubloon (ZTD) – managed by a supra-national organisation would make it more difficult for any one country to get into too much debt to another. If the supply of ZTD in issue were controlled properly – say by expanding it in line with global GDP – it would serve as a steady store of value, with little risk of devaluation.

Moreover, a credible ZTD would have many of the advantages of the now-defunct gold standard. It would be strictly limited in supply and readily acceptable everywhere. Indeed, it would be even better than the yellow metal, which is after all too cumbersome for a modern economy and too scarce to serve as a measure for international trade.

In sum, the ZTD would add much needed ballast to international finance. And China would not be alone in promoting this single currency. Russian authorities have been thinking along similar lines.

So why not get cracking? There are many obstacles: most notably getting the IMF up to the task. Nor is China in any position to move quickly. A truly global reserve currency would have to be based on a basket of world currencies, which would include the renminbi. China would have to make its tightly controlled currency freely convertible – which it shows no desire to do.

Indeed, China probably has other things in mind than financial stability, such as augmenting its global financial sway. Right now, the Middle Kingdom has only a 3% vote in the IMF, no more than Belgium, because votes are linked to each country’s contribution to the fund. Were China able to claim credit for its prodigious foreign reserves, it could replace the US at the top of the table.

At best, China’s proposal is self-serving. At worst, it could be merely another manifestation of growing hostility towards the US – to be filed alongside recent protectionism, naval skirmishes and Chinese criticism of US spending habits. That political undercurrent is a shame. Paper gold looks like one of the best ideas to come out of the financial crisis.

March 24 2009

Pernicious practice

By Hugo Dixon

Will they ever learn how dangerous it is to borrow in foreign currency? To judge from the turmoil in Eastern Europe, the answer is no.

Time and again, individuals, speculators and governments have engaged in foreign currency borrowing binges. The attraction is obvious. A Hungarian homeowner can borrow much more cheaply in Swiss francs than in forints. Similarly, in the run up to the Asian financial crisis a decade ago, Thai companies could get better rates in dollars than in baht.

Cheap borrowing fuels asset price booms. Sucking in capital from abroad also boosts the local currency, allowing the country to splash out on imports and run deficits. Everybody feels rich and lives beyond their means -- for a while.

But time and again, the foreign currency speculators – and that is exactly what they are – get burnt. Bubbles burst and local currencies collapse. Debts incurred in foreign currencies balloon when translated into local currencies. Borrowers go bust. Banks that have lent to them require bailouts. Entire countries get sucked down the plug-hole.

The pernicious practice must be reined in. It makes more sense to focus on the lenders than on the borrowers. They take on a huge risk in extending credit in a foreign currency. Devaluation brings defaults and plummeting values of collateral.

The classic way to deal with banks that take excessive risk is to require them to hold more capital. Such an approach should be adopted here too. That will make it much less profitable to play with fire in this way. As a consequence, lenders will stop the practice entirely, make smaller loans or push up interest rates. The result would be to make foreign currency loans far less attractive for borrowers.

The problems of the last batch of foolish cross-border lending will be hard to resolve. But it should not be too hard to prevent a recurrence. Cracking this problem should be high on the agenda when world leaders meet in London next month to reform the global financial system.

March 5 2009

Making the markets friendly

By Edward Hadas

The latest pop in the oil price caught almost everyone by surprise. But the 73% rise in less than three months was hardly a unique phenomenon in the commodities world. It's been up big and down big for years for everything from sugar to steel. Investors may be used to hyperactive spot and futures markets, but they make no sense.

If supply and demand ruled, the oil price should hold reasonably steady over the years. After all, consumption has increased at fairly consistent 1.5-2.5% annual rate for the last two decades. If demand shifts for a while, there should be no problem. There's lots of inventory, oil doesn't go bad and production can be ramped up or cut back quickly. An active cartel helps keep order.

But predictable demand, inventory cushions and flexible supply haven't helped. In the last decade, the price moved wildly: up from \$17 to \$145 a barrel, then down to \$34 and finally up again for a few moments to \$60.

The gyrations may make speculators happy, but everyone else suffers. Producers which have to make multi-decade investment decisions are left to guess the most important variable – the price. Consumers can't decide if they should buy gas guzzlers or hybrids.

While governments of commodity-exporting countries may like the booms, they can't make realistic plans. The price accordion has squeezed Russia, for example, terribly. And the price shifts make life hard for policymakers everywhere. Inflation rates are hard to interpret, current accounts move all over the place and excess funds from commodity exporters distort global financial markets.

Why so much variation? And what can be done about it?

The best explanation for the dramatic price gyrations was provided in 1985 by Jeffrey Frankel, an economist who now teaches at Harvard University. Commodity prices fluctuate with the financial times. Ample supplies of cheap money deepen the pockets of industrial buyers and encourage speculators to pile in, while tighter money can bring prices down fast and hard.

There are many caveats, but the basic Frankel argument makes sense. The best way to make commodity prices more stable – and more helpful – is to make financial conditions more stable. Then prices would move, but only modestly.

But there's no need to sit and wait for global financial peace to arrive. Everyone involved should admit the "financialisation" of commodities is a problem. That would be a big shift. In recent years, both producers and suppliers sides have been drawn to short-term pricing like moths to a light bulb. They talk about trusting market signals, but the signals have been going haywire.

There two ways to get the financial tail to stop wagging the economic dog.

First, commodities should be treated like another financial product. That means that the authorities should keep a watchful eye out for bubbles. Regulators have learned that to keep asset prices under control, leverage needs to be restrained in banks and brokers. Commodity traders should be included in the net. Soaring prices should be met by higher margin requirements.

Second, prices should be set over longer terms. Ideally, projects that have a 20-year life should have a 20-year price, adjusted for changing production costs. That sort of exact match probably isn't possible. But if producers, customers and governments stopped jockeying for short-term advantage, they could find ways to keep down variability.

One way is through long-term futures. These markets exist, but are too thin to be of much use. The long-term future price usually follows the short-term. Another technique is long-term contracts between producers and customers. These used to be normal for many commodities. They should be brought back.

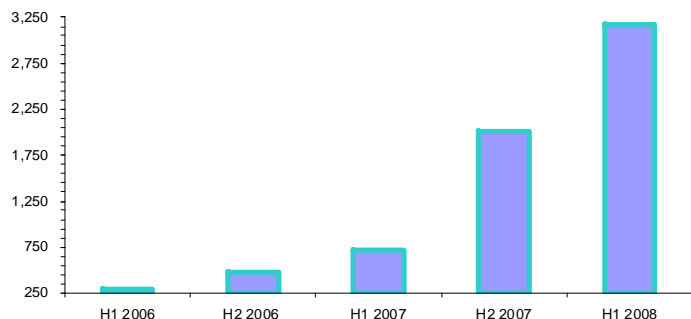
The Chinese seem to be thinking along these lines. That's the best explanation for their substantial investments in mines and miners around the world.

The economics of commodities are never going to be easy. The gap between the low and high cost producers is often very wide – from less than \$5 to more than \$50 a barrel in oil. That leaves a lot of money to fight for. Also, governments always want to get their fair, or unfair, share.

But the world can do much better than it has in the last decade. Everyone will ultimately be better served if prices are more closely related to costs than to financial conditions.

May 14 2009

Credit Default Swap market
Gross market value, billions \$



Source: Bank of International Settlements, December 2008 Quarterly Review

Chapter 4

Controlling the casino

Financial institutions engaged in too much speculation during the bubble. The main culprits were banks themselves – with their so-called proprietary trading arms. It was too easy to borrow lots of short term money and then sink it into risky long-term assets.

“Shadow banks”, as they are known, are also culprits. The category normally includes structured investment vehicles (SIVs), collateralised debt obligations (CDOs) and other members of the alphabet soup brigade. When the shadow banks collapsed, they inflicted huge losses on the banks, so increasing their pain.

Some politicians, especially in France and Germany, have also pointed the finger at hedge funds – and argued that they need tough regulation. In theory, these leveraged investors could also cause damage. But they haven’t been too troublesome in this crisis.

The way forward is not to regulate the shadow banks directly but, instead, to regulate the flow of credit to them from the banks. If they can borrow less money, they will be less likely to collapse. Meanwhile, the banks’ own trading activities do need closer regulation. An especially tough regime for prop trading is one possibility. Another is to make sure banks build up fatter liquidity buffers. That way the banks will be less likely to hit the wall when short-term funding dries up.

What’s more, the system for regulating banks needs shaking up. They should be subjected to regular check-ups. And, in the US, the patchwork quilt of regulatory bodies should be streamlined.

Shadow boxing

By Hugo Dixon and Richard Beales

Hedge funds and the rest of the so-called shadow banking system are almost certainly going to be brought into the regulatory net. But governments should not try to supervise them directly. It will be far more productive to focus on how they go about borrowing to leverage their investments.

The political momentum is building for regulating shadow banks in advance of April's meeting in London of representatives of the G-20 big economies. That much is clear from the European leaders' summit over the weekend. Even Britain, home to the lion's share of Europe's hedge funds, signed up to a proposal for "appropriate oversight" for hedge funds and other "pools of capital" which could pose a systemic risk. That proposal sounds similar to one advocated last month by Paul Volcker, one of President Obama's top economic advisors, in a report for the Group of Thirty think tank.

Although hedge funds themselves have not caused big problems in the current crisis, the broader shadow banking system has. Hedge funds, structured investment vehicles, collateralized debt obligations and other members of the alphabet-soup brigade took on oodles of leverage in the good times to buy assets which turned out to be toxic.

This caused two problems. First, because the shadow banks moved as a herd, they helped inflate the bubble and then exacerbated the bust. Second, shadow bank losses knocked holes in the balance sheets of the ordinary banks which had lent to them.

There is a strong case for regulation. Watchdogs are justified in asking for information that could help them identify systemically risky operations – by virtue of size, leverage, investment style or otherwise. They also have a responsibility to encourage or insist upon disclosure and practices that help protect investors, especially in jurisdictions where relatively unsophisticated investors can access hedge funds and other potentially risky holdings.

But supervising the myriad shadow banks – hedge funds, SIVs, CDOs and the rest – will be impractical on a day-to-day basis. Regulators have failed to monitor banks adequately. The notion that they can keep on top of every hedge fund manager is fanciful.

And focusing only on the biggest shadow banks – on the theory that they are the systemically important ones – won't necessarily work either. Giant hedge funds could just split themselves into smaller units. And, given the herding mentality, lots of little shadow banks can cause havoc as easily as a few big ones.

The better solution is to focus on the biggest single risk factor: the lending of money by ordinary banks to their shadow brethren. If there wasn't any leverage, there would be much less of a problem.

More specifically, regulators should monitor the interface between ordinary banks and shadow banks. Each part of the shadow banking system may require its own solution. But with hedge funds, the right approach should be to set detailed rules on margin lending by banks' prime broking units.

Indeed most prime brokers already have the ability to apply such rules, and do so up to a point. That's one reason hedge funds have weathered the crisis somewhat better than the banks, which didn't apply the same discipline to their own borrowing. And with both hedge funds and lenders doubly cautious in the wake of market turmoil, hedge fund leverage has declined substantially. A Thomson Reuters Lipper survey last month found nearly 80% of hedge funds are now borrowing a dollar or less for each dollar of investor capital.

Regulators, though, need to plan for that trend reversing in the future. A one-size-fits-all policy won't work. Some types of assets will require fatter margins than others. But regulators do at least already have some sort of framework for assessing the riskiness of different assets. They do it in the context of setting capital requirements for banks and insurance companies, for example.

Equally, regulators shouldn't necessarily insist on a hard and fast ban on leverage above a certain level. An alternative could be to say that if banks want to provide high levels of debt to their clients, they

should then hold extra capital themselves. That would ensure that the overall financial system – banks plus shadow banks – was adequately capitalized.

Such a system will still be hard to police. But it will be far easier to control a few dozen prime brokers than thousands of shadow banks.

February 23 2009

Proper thinking

By Christopher Hughes

Proprietary trading is already almost a taboo business in investment banking. Now regulators are adding to shareholders' pressure on the activity.

European authorities have made vague pronouncements about tighter supervision of prop trading. The UK financial watchdog wants banks to hold as much as three times more capital against trading activities than is currently required. Before adjustments, that means one-third of the returns.

Prop has already generated colossal losses during the credit crunch. Can it survive this latest onslaught?

It is unfashionable to say so, but some bank prop business is valid. It captures full value from the infrastructure that investment banks possess for trading on behalf of clients. The firm profits from its execution machinery and investment research. In short, prop trading puts a little spare capital to sensible use.

The difficulty is that often more than a little capital has been dedicated to the business. Banks have never broken out proprietary activity, but many trades described as "client driven" look more like prop risks – sometimes outsize ones. The structured-credit holdings that have lost banks so much money were often inventory held for clients, which effectively became prop positions.

Also, during the go-go years, prop risk became spread across business units, often with no coherent oversight. Hence surprises, such as sudden huge losses on short positions in Volkswagen shares in the fourth quarter of 2008.

Regulators are reasonable in wanting fatter capital cushions. But a one-size-fits-all capital requirement would be too blunt. Some prop strategies are more illiquid than others. Increased capital requirements could also lift the cost of client trading.

Of course, lower returns may encourage prop traders to migrate to the hedge fund community. But regulation should not augur the death of bank prop. Hedge funds are likely to be subject to indirect controls on their leverage too. And as some investment banks exit prop trading, so the business will become more attractive for those who remain.

The big challenge will come when the appetite for risk returns. Then banks and their shareholders will also regain their taste for prop trading. Regulators need to impose a framework beforehand, to ensure that the appetite does not become gluttonous.

Context news: Adair Turner, chairman of the UK Financial Services Authority, said the regulator's plans to tighten bank supervision included measures requiring banks to hold up to three times as much capital against their trading assets, the Financial Times reported. The comments were made to a hearing of the UK Treasury Select Committee on February 25.

A European Union task force headed by Jacques de Larosière, a former Bank of France governor and former head of the International Monetary Fund, has advocated the creation of a pan-European body to coordinate regulation of banks, insurance companies and markets.

February 26 2009

Coming off life support

By Christopher Hughes

Banks barely gave a second thought to liquidity before the financial crisis. Regulators will make sure they pay more attention in the future. Banks will have to raise more deposits, tie up more of their assets in low-yielding, liquid securities, and be subject to greater disclosure.

Liquidity crises have been at the centre of the credit crunch since the summer of 2007. Northern Rock in the UK and Indymac in the US suffered a run on their deposit bases by retail customers. There were also wholesale "runs", when providers of short-term funding simply didn't renew commitments. Those triggered the collapses of Bear Stearns and Lehman Brothers.

Liquidity risk is inherent to banking. The business is founded on a mismatch between borrowing over the short term and lending for the long term. The problem in recent years is that this mismatch became excessive.

Liquidity crises are bad enough, but they can lead to something worse. A bank that needs to sell illiquid assets in a hurry will have to accept large discounts. A liquidity problem becomes a solvency problem. Also, liquidity squeezes tend to be contagious. When one financial institution tries to boost its liquid resources, other institutions suffer as the strained institution takes liquid assets out of circulation.

There is now global agreement that banks cannot be trusted to manage their liquidity well. That's the only possible conclusion. It's not just that spreading liquidity woes create a moral hazard. The fact that most Western banks are still relying on central banks for liquidity nearly two years since the crisis broke is a clear sign that a better system is needed.

Pioneering a rulebook for bank liquidity

The G20 envisages this life support being switched off, with robust regulation put in place to prevent a recurrence of the problem. The plan is for a partial framework to be in place “by 2010”. How will it work?

In September, the Basel Committee on Banking Supervision published 17 principles as guidance for national regulators - the first ever attempt at global standards. So far only the UK Financial Services Authority has said how it might implement the BCBS's thinking. The US Federal Reserve and Securities and Exchange Commission have acknowledged the need for improved liquidity regulation, without being specific.

The FSA and BCBS blueprints share the same broad aims. First, to prompt a revolution in the way that banks assume and manage liquidity risk – so that the risk is reduced. And second, to require banks to hold a bigger buffer of liquid assets for when the risk of a crisis materialises.

Satisfying the first of these will create complex and expensive new processes for banks. Management will have to identify the level of liquidity risk appropriate to their business model and articulate a detailed liquidity risk-management policy. Banks will be incentivised to take more retail deposits and rely less on short-term wholesale funding.

Every legal entity – and potentially even some product lines – will have to satisfy discrete liquidity tests. Subsidiaries will not be permitted to rely on other parts of the same group for liquidity. That was a key lesson from the collapse of Lehman Brothers, when \$8bn of cash was transferred from the Wall Street bank's London operations to its US parent company in the days running up to its collapse. PricewaterhouseCoopers, administrators to Lehman's European business, has itself called for regulations on local liquidity.

As for liquidity buffers, these will have to comprise more and higher quality liquid assets. The FSA wants banks to hold a higher proportion of assets in government bonds. This is not inconvenient for the UK government, which will have to issue billions of pounds over the coming years to fund its stimulus programme.

Specific liquidity rules

These are mere broad-brush prescriptions. Unlike bank capital, where there is a common standard that a bank's equity cushion should be at least 4% of risk-weighted assets, standardised measures for bank liquidity are hard to devise. But that isn't stopping regulators from trying.

The BCBS has called for banks to make quantitative disclosures on their liquidity – for example, data on their liquidity buffers, collateral requirements if credit ratings are downgraded, and the metrics used in internal liquidity models.

Given that market confidence is the bedrock of sound liquidity, such forced disclosure would help keep the banks honest. But banks generally hate all disclosure, and the idea has predictably met with resistance from the sector. The FSA chose not to include it in its own consultation document.

Disclosure can have its own problems. Quantitative data, especially in such a slippery matter, can generally be manipulated. Banks could game the numbers when disclosure dates are approaching.

The FSA has suggested introducing a so-called "core funding ratio". This might measure a bank's deposits and long-term wholesale funding as a proportion of total assets, according to a person familiar with the regulator's thinking. Rapid changes in this measure would be a red flag.

This approach is simple, but it could be simplistic. The cut-off point for long-term funding would create a binary dividing line between “good” and “bad” funding. Putting variable weights on different maturities might help, but at the cost of added complexity and a loss of intuitive appeal.

The core funding ratio should also take into account the other side of the balance sheet. Limited liquidity on the funding side isn't as big a risk if what is funded is assets that can easily be disposed of.

A drift to deposits - with consequences for non-banks

Where does this leave the banks? Most likely, they will end up with an abstruse international code, implemented by local regulators with wide variations. They may try some regulatory arbitrage. But at least some short-term wholesale funding will be replaced with deposits.

Such a shift may be inconsequential for some, such as HSBC and Standard Chartered, but seismic for banks whose balance sheets are inflated by sizeable investment banking operations. Banks may end up having to make regular detailed disclosures about their liquidity position. Vague reassurances about “swimming in liquidity”, which have reverberated throughout the credit crisis, will not suffice.

The move to deposits will have knock-on effects beyond banks. Tighter liquidity management may lead to less “maturity transformation” – fewer long-term loans for companies and consumers. And the euros, dollars and pounds that previously went to non-banking institutions such as hedge funds and insurance companies may now drift back to the banks as deposits.

April 15 2009

Regular check-ups

By Rob Cox

What's the future of US financial regulation? Legislators, regulators and bankers needn't look too far for an answer. A sort-of functional blueprint may be under their noses – in the form of the stress tests just completed on the 19 largest financial institutions.

These examinations forced regulatory bodies, including the Federal Reserve, Treasury, Comptroller of the Currency and others into unprecedented cooperation. And by comparing big financial institutions, regional banks, credit card issuers, auto financiers and Wall Street firms, regulators mitigated the so-called “Lake Wobegon” effect, where everybody evaluated in isolation comes out above average. These ambitions should be part of any reform to the financial oversight system.

The stress tests were not perfect. For one, the assumptions behind them are still being argued. With another 539,000 Americans losing their jobs in April and the national unemployment rate rising to 8.9 percent, critics of the tests' worst-case scenario of 10.4 percent next year say the economy is already nearly there.

Conversely, some bank executives argue the tests were too tough. Regions Financial, for example, disagrees with the future losses assumed for its commercial real estate portfolio, a prime factor in regulators' decision to order the Alabama-based bank to raise \$2.5 billion in new capital.

But applying a uniform set of standards horizontally across the financial sector is logical, even though it is difficult to strike a balance between the big picture and legitimate differences in banks' circumstances.

Up until now, individual regulators have mostly conducted examinations of banks one at a time. Even though stress tests have long been part of that process, it's easy to see how watchdogs working in vertical silos might conclude almost all banks are stronger than average.

But when multiple examiners mark each firm's performance against others on all manner of parameters, potential weaknesses become easier to detect.

Sure, stress tests conducted this way can't avoid some subjective and simplified assumptions. But it would be a mistake to let that obscure the merits of adopting the great exercise's comparative and coordinated inter-agency approach to the assessment of banks' capital strength.

May 11 2009

Take a chainsaw to it

By Robert Cyran

US financial regulators have spent the last several years in a race to impotence. The clear winner of this chase to the bottom is the Office of Thrift Supervision (OTS), the agency that served as chief financial regulator to a motley crew of credit crunch losers, including Countrywide, Washington Mutual, IndyMac and American International Group. Shuttering OTS would be a good first prize.

Other regulators haven't exactly covered themselves with glory. In sheer numbers, more small state-chartered banks regulated by the Federal Deposit Insurance Corporation have failed. In size, only the government's determination that Citigroup was too big to fail and must be bailed out prevented the Comptroller of the Currency from winning the gold medal for incompetent regulation.

But the OTS exhibited the worst symptoms of regulatory capture – that's to say taking the side of the industry it regulates instead of the public. Some signs are trivial but telling. It called institutions under its oversight "customers". Others are extraordinary. It allowed multiple thrifts, among them failed IndyMac, to backdate capital infusions so that earlier quarterly financial statements looked healthier than they would have done.

Without this action, IndyMac probably would have closed its doors sooner, possibly reducing associated losses to FDIC and depositors - the bleeding usually increases as undercapitalised financial institutions stagger on. Scott Polakoff was replaced as acting head of OTS and put on leave at the end of March while the backdating matter is being investigated.

The reasons for this regulatory version of Stockholm Syndrome are multiple. The minimal number of bank failures in the middle of the decade bred widespread complacency among all financial regulators. The Bush administration tended to sympathise with the idea that markets regulate better than federal agencies. And the growth of unregulated mortgage brokers and other non-bank financial companies made even OTS oversight look stringent by comparison.

But OTS funding also probably played a key role in its failures. The agency's budget comes almost entirely from fees levied on the thrifts it regulates. Fees are based upon asset size. This structure gives OTS, or indeed any regulator, a potential incentive to first try and lure financial institutions into becoming thrifts and then look the other way if they enlarge their asset base through questionable lending.

These conflicts of interest were worsened by financial consolidation. A handful of institutions accounted for much of OTS's budget – Washington Mutual, for example, provided about 12% of the agency's operating funds, according to

Patricia McCoy, a professor at the University of Connecticut School of Law who has testified to the US Senate on the matter.

OTS rejects the notion that it encouraged or even temporarily benefited from regulatory arbitrage. But this is hard to square with history. Countrywide switched to the OTS in early 2007, a move that did consolidate the company's oversight but was also widely attributed to the attractions of the agency's perceived lighter touch.

That switch meant four of the five biggest issuers of option ARMs – a particularly virulent form of mortgage loan that former OTS head John Reich had praised in speeches – were under OTS supervision. The fallout from the housing downturn forced Countrywide into Bank of America's arms. The other three – IndyMac, Downey Financial and Washington Mutual - all failed.

So what can be done to prevent this happening again? Funding regulatory agencies at least partly through Congressional appropriations rather than user fees might help cut the ties between industry and regulators. It's no panacea, though. The predecessor to OTS was abolished precisely because lawmakers leaned on regulators – and threatened to cut their budgets - to stop an investigation into Lincoln Savings and Loan, the thrift controlled by Charles Keating which subsequently went bankrupt. But at least the distance between regulator and regulated is greater when funds come from Congress.

A better idea is regulatory consolidation on the federal level, with broad new statutes that apply to surviving regulators. For example, underwriting should be based on consumers' ability to repay. Common lending standards on sensible principles would limit the wiggle room in which toxic lending products thrive. And reducing the number of agencies should reduce regulatory arbitrage.

After all, Washington bureaucrats gain prestige and influence by winning turf wars, not unlike the private sector companies they oversee. Minimise the soil that can be fought over, and financial institutions have less ability to play one official off against another.

April 8 2009

Chapter 5

Head I win, tails you win

The financiers who ran amok had an incentive to take excessive risks. If their bets paid off, they ended up multimillionaires. If their bets failed, the penalty was modest. Often there was nothing worse than a low bonus. If one job was lost, another was usually available. And the leavers sometimes managed to slink off with fat bonuses or rich pensions.

Such “heads I win tails you lose” compensation schemes are crazy. The authorities now seem determined to root them out. The main idea is to keep bankers from collecting bonuses for short-term performance on positions that ultimately prove disastrous. Bonuses will be paid out fully only after a delay several years – and some promised payments can be clawed back if profits turn into losses.

Another intriguing idea, floated by the UK regulator, is to force banks which keep their skewed incentive schemes to hold more capital. That way, they would have more of a cushion to protect them against the risks their traders are running.

It's not just bankers who have these one-way bets. Hedge funds do, too. The government doesn't need to regulate their compensation. But investors should definitely put pressure on fund managers to make sure that the gains and losses are more evenly distributed.

Some people think the solution to the bonus problem is lower bonuses and higher basic salaries. That would just give out rewards without any attention to success. That's cock-eyed. The pay system has been abused, but bonus shouldn't be considered a dirty word.

Not a dirty word

By Hugo Dixon

Bonuses are bad, right? So it's better to pay bankers fatter base salaries. That is the thinking behind the latest proposed reforms from the UK's Financial Services Authority. It also seems to be influencing UBS, which is pushing up base salaries after slashing bonuses.

The bonus culture in the City of London and on Wall Street has certainly been abused. But the idea that the financial services industry would therefore be better off with higher base salaries doesn't seem right.

Bonus should not be viewed as a dirty word. In a well-functioning organisation, bonuses fulfil two valuable purposes. First, they act as an incentive – motivating and rewarding high performance by individuals. Second, they act as a sort of profit share - providing flexibility in the cost base. When times are tough, as at present, overall compensation costs can be hacked back.

Of course, the bonus model has not been functioning well in the financial services industry. Bonuses have fallen, but failed or failing banks such as Lehman Brothers and Merrill Lynch have continued to pay out fat bonuses to staff.

The FSA has reacted to these outrages by arguing that “fixed pay should be a sufficiently high proportion of total remuneration to allow for a flexible bonus scheme”. But this is precisely the wrong sort of reform. By encouraging firms to put up their base salaries, it will make their cost bases more inflexible and less able to withstand future downturns.

Regulators should instead focus on linking bonuses to genuine performance and genuine profits. And, to be fair to the FSA, it is doing that too. For example, it says that performance should be

judged over several years, that two-thirds of bonuses should normally be deferred and that long-term incentive plans should be risk-adjusted.

But the regulators don't also need to promote higher base salaries. Far better just to make clear to firms that bonuses are bonuses, period. That means that, in a really bad year, most employees should get next to nothing.

March 3 2009

2 and 20 vision

By Hugo Dixon

It wasn't just traders who had incentive packages that amounted to one-way bets. Hedge fund managers had "heads-I-win, tails-you-lose" incentive structures too: the notorious 2 and 20 system. Every year, they receive a 2% fee for managing investors' money – plus 20% of any profit. The crashing and burning of hedge funds is exposing the folly of this system.

In the same way that traders' one-way bets encouraged them to take big risks with banks' capital, the hedge funds' 2 and 20 system gave them an incentive to take big risks with investors' capital. The bigger the fund they accumulated, the fatter the management fees they took home. And when performance was good, the 20% "carry" made many as rich as Croesus – so much so that traders working inside the banks looked like poor relations.

Such fortunes, which occasionally ran into the billions, were justified on the basis that the hedge fund managers were super-smart. Well, maybe. But that didn't make them infallible. A string of former high-flying hedge funds are now caught in a vicious spiral of poor performance and redemptions. Some are closing their doors. Insofar as the managers reinvested their fortunes in

their own funds, they will also be suffering. But the beauty of the 2 and 20 system is that it's a one-way street. They don't have to give back last year's carry if this year's performance is appalling.

Many funds do have "high water marks" - which mean that after a dire year like the present they will not be able to earn any future carry until they recoup their losses. But this isn't quite as strong a protection for investors as it looks. Precisely for this reason many managers are expected to close shop and, if they can, start new funds where they can start earning carry with a clean slate.

The funds' losses create less systemic risk than traders' losses as they are one removed from the heart of the financial system. However, they could cause trouble for banks that lent them money. What's more, panicked selling by funds can drag down the value of everybody's assets – causing systemic problems in the way that the Long-Term Capital Management crisis did a decade ago.

But the biggest losers will be the fund's ultimate investors who allowed managers to get away with these one-way bets in the first place. Regulators are now putting pressure on banks to change their incentive systems so that traders can't get fat bonuses on the basis of short-term performance which is subsequently reversed. Hedge fund investors should do the same with their managers.

October 17 2008

Mismatch paddy whack

By Rob Cox and Richard Beales

Unlike US banks, hedge funds haven't been lining up for government bailouts in the wake of losses they can't handle. But the funds do share one Wall Street problem: a massive mismatch between the short-term funds they take in and the long-term bets they make. Without a rethink of their business models, many in the hedge fund business risk going the way of the investment banking dodo.

Recall the nightmare on Wall Street. Going into 2008, America's five big investment banks held trillions of dollars in long-term and illiquid assets that were financed largely by short-term borrowings. That did not work out so well. Two of them disappeared. Another was swallowed by a traditional bank, and the last two had to don the sober garb of regulated, deposit-taking banks to survive.

In the hedge fund industry, which at its peak last year managed some \$2 trillion, the analogous problem runs like this: Investors hand their money over to hedge funds, which typically charge fees of about 2% a year plus a fifth of any profits, on the basis they will, mostly, make some money even when pandemonium breaks loose. This promise of what the industry calls absolute return went unmet last year. The average hedge fund lost nearly 20% of its value in 2008, according to Hedge Fund Research.

As a result, many investors understandably wanted their money back. The problem is, hedge funds have in many cases loaded up with investments they can't easily sell - at least not without incurring a big loss. That's not just bad for the investors who want out. It also creates collateral damage to those who want to stay in the funds.

For funds that want to continue letting investors pull their money out on relatively short notice, one answer is to cut out the adventurous stuff and stick to the most liquid markets, like those for stocks, government bonds and the like. Hedge fund grandee Paul Tudor Jones is doing just that with his BVI Global fund.

Some managers still want to place complex, illiquid bets. For them, the obvious solution is to look for longer-term capital, akin to the way Goldman Sachs and Morgan Stanley are pursuing low-cost, relatively stable deposits. Lately, many hedge funds have been managing this process on the fly by putting up so-called gates that prevent investors from redeeming their money, at least temporarily, as Jones did with BVI Global.

But this approach is a stop-gap that comes at huge cost. For one thing, it enrages investors, who thought hedge funds presented a mostly liquid form of investment. And to mollify limited partners, market jargon for investors, some funds are voluntarily emasculating themselves by reducing, even eliminating, management fees and taking a smaller cut of profits, should there be any.

For the longer term, some funds are restructuring with a view to locking investors in for years rather than months or quarters. At least one is pushing this idea further still. Jeff Ubben, founder of San Francisco-based ValueAct Capital, is taking a page from the private equity business and applying it to his hedge fund. The idea is that the new investors in his next fund, which he's targeting at \$3bn, must commit their cash to him for five years, about even with the effective life of a leveraged buyout fund.

That's a long time, especially in the hedge fund world. But here's the carrot. In return, ValueAct promises not to take a penny out of the profits until the end of the period, when the final tally will be real, not just on paper. That's not all. Breakingviews.com has learned that Ubben and his crew will

not collect a cut of the gains unless they generate returns of at least 12.5% a year, or about 80% over the life of the fund.

ValueAct will charge a 2% annual management fee. That will keep the firm going while it researches its stock picks and fights the occasional proxy battle, as is Ubben's wont. But with a track record of 20%-plus annual returns over the last nine years, he's clearly confident he can make up the difference. In doing so, he may also be on to a new business model for a good portion of his industry.

September 22 2008

Chapter 6

Battling incompetence

The failure of the financial system wasn't just down to greed. Incompetence – right across the board – played a big role. Regulators weren't smart enough. Young bankers didn't have a clue about the past. Old bankers were out of touch with new financial wizardry. And bank directors weren't on top of their jobs.

We have some ideas to improve all of these problems.

- Regulators should be better paid, so the best don't just get recruited by the banks and turned from gamekeepers into poachers.
- Young bankers should be forced to study financial history.
- Old bankers should brush up on their derivatives.
- And directors should be forced to endure an inquisition before they get appointed – an idea that the UK's FSA has adopted.

Philosopher kings

By Hugo Dixon

Could a way of preventing future banking crises be found in Singapore?

Much attention has rightly been given to how bankers' incentives encourage excessive risk-taking. But too little has been paid to the incentives of those who monitor them.

The disparities in compensation between a financier and a civil servant are huge in most parts of the world. There are, of course, some public-spirited individuals who are prepared to forgo the chance to get rich because they see a noble purpose in serving the broader interest. But too many smart people have been lured out of agencies like the US Securities and Exchange Commission or the UK's Financial Services Authority by the promise of lucre.

In Singapore, though, things are different. The island state seems inspired by Plato's Republic, in which philosopher kings guard the public interest. And fitting with such a philosophy, Singapore rewards its public servants handsomely. Not surprisingly, the public sector is seen as an attractive career for the smart set. It may also be no coincidence that the country's banks have so far weathered the global storm pretty well.

Tony Tan, the deputy chairman of the GIC, one of the country's sovereign wealth funds, warmed to this theme at the World Economic Forum in Davos last week. He rightly pointed out that any reform of the global financial architecture would have only limited success unless there were also enough talented people to manage a new regulatory structure.

Now the financial crisis is already reducing the bonuses available on Wall Street and in the City of London – narrowing the compensation disparity in favour of finance. And a few high-

profile financiers have joined the public sector without receiving any salary at all – notably Mervyn Davies and Paul Myners, both of whom have become UK ministers. But these are rare creatures. Not only have they already made their millions; they have each received something money can no longer buy – a seat in the House of Lords.

As world leaders draw up plans to reform global finance at the G20 summit in London in April, they must not forget the incentivisation of regulators. Put simply, if they pay peanuts, they will continue to get monkeys.

Mervyn Davies was a director of Breakingviews.com before he joined the UK government as trade minister in January.

February 3 2009

Study history, young man

By Hugo Dixon

It's time for the financial industry to go back to school – to study financial history. Rapid expansion, early retirements and lack of study mean that there are too many youngsters who have, at best, a hazy knowledge of their profession's past.

True, there is some experience about. The dotcom bubble is still a vivid memory for many. But few were practising professionals during the 1980s Japanese bubble, let alone the oil, inflation and banking crises of the early 1970s. As for study of financial history, it's often thought of as something to be taken up seriously in retirement, along with gardening or art collecting.

What's more, the weight of history – the grim persistence of the pattern of excess followed by disaster – is felt mostly by grey-beards who don't even want to understand modern financial

technology. That ignorance left them almost speechless when the time came to complain about the risks of securitisation, let alone the structure of CPDOs.

Historical knowledge doesn't guarantee prudence. Ben Bernanke, the head of the US central bank, is an expert on the Great Depression, but seems to have forgotten about the Great Inflation. Still, in an atmosphere of general ignorance, it is hardly surprising that the world's financiers threw caution to the winds in recent years.

To improve the odds, future financiers should be made to study history. As it stands, mandatory exams such as the US Series 7 or those given by the UK's Financial Services Authority only include technical matters such as the basics of securities and financial derivatives. Financial history isn't even an option.

The next generation of aspiring bankers, traders and fund managers should be quizzed about the South Sea Bubble, the crash of 1929 – and the great credit crash of 2007. And while we're at it, why not send the fuddy-duddies back to school, too, to brush up on CDO squareds?

Context news: The UK's Financial Services Authority exams are required by anybody who wants to take an advisory role in finance. They do not contain a financial history component.

In the US, individuals wanting to sell securities are required to take the Series 7 exams. They have no financial history component.

March 25 2008

Enter the Star Chamber

By Hugo Dixon

The original Star Chamber was used in medieval Britain to try people who were so powerful that ordinary courts could never hope to convict them. A modern version could be used to hold banking bosses in check.

In the roll call of banks that have floundered in the current financial crisis - Bear Stearns, Northern Rock, Citigroup, UBS, Merrill Lynch, Royal Bank of Scotland – a common element was the weakness of their boards. Either the chief executives themselves didn't have a grip on their businesses or the non-executive directors didn't have a grip on the bosses - or both.

Any post-crisis reform of the financial system should include measures to strengthen boards.

Start with the chief executives. Bank bosses should be required to endure periodic grilling by a panel of regulators on the risks they are running and the measures they are taking to manage those risks.

Bank chief executives already have meetings with regulators. But these are not normally aggressive. The new world of the Star Chamber would be tougher. Crucially, bosses would have to go in without any flunkies to help them out with tricky questions.

The bankers would be asked to explain things like "what is a CDO-squared?" If they are flummoxed, the natural follow-up question would be: "Why is your bank investing in stuff that you don't understand?"

(A CDO-squared, incidentally, is a collateralized debt obligation that invests in other CDOs. And a CDO is a complex vehicle that invests in pools of assets and issues several classes of

securities structured in such a way that investors in different classes take different risks and receive different returns.)

Bank bosses wouldn't like such torture. But given that governments ultimately stand ready to bail out banks that run amok, it would be perfectly legitimate. The Star Chamber would help regulators spot problems and nip them in the bud. It would also give bank bosses a powerful incentive to understand the risks they were running – and that should mean better risk management.

The Star Chamber could be used for non-executive directors too – in a modified way. One problem with bank directors is that few of them know much about banking and can't therefore hold the executives to account. Because of this, several of the banks that have suffered in the recent crisis – including Citi, UBS and RBS – are trying to recruit new directors who do have more financial expertise.

It would be too much to expect all bank directors to be experts in finance or risk management. But those who sit on the bank's risk committee – which, in many cases, is incorporated within the audit committee - certainly should. Before being appointed, they too should endure a modified version of the Star Chamber and be vetted by the regulator.

Why, one might ask, would non-executive directors put themselves through such a grilling? The answer is that they wouldn't – unless they were also paid more. At present, non-executives get paid a pittance. At RBS, for example, they receive a basic £70,000. At Citi, one of the most complex institutions on the planet, they receive \$225,000.

Going forward, the pay of bank non-executive directors should probably be roughly doubled. Those sitting on the risk committee should receive quite a bit extra to make it worth their while.

To prevent costs exploding, banks should simultaneously roughly halve the number of non-executives. There are far too many of them anyway. RBS had 11 last year; Citi had 12 at one stage earlier this year.

A small group of directors who know what they are doing, spend a proper amount of time on the job and are paid appropriately would be far more effective at holding a chief executive to account than large boards made up of the boss's buddies who don't do their homework. They would constitute the bank's own internal Star Chamber.

May 27 2008

Chapter 7

Don't regulate everything

Most of this book is full of ideas for regulating the financial system. But regulation can also be excessive. We think some fashionable ideas about regulation are wrong. We discuss four of them:

- Glass-Steagall. We don't think there should be a new version of the Depression-era US legislation which divided commercial banks from investment banks.
- Short-selling. We don't want it banned. Short-sellers are not the creators of doom – merely its messengers.
- Mark-to-market accounting. We don't want this messed with. The sooner assets are marked down, the faster banks will deal with their problems.
- Credit ratings. The problem with ratings is that they have been too deeply entrenched in the system. Their semi-official status has proved counterproductive. We think deregulation, taking away official recognition of ratings, is a better approach than regulation. But that may be too much to hope for.

Through a Glass darkly

By Hugo Dixon

Why would anybody run a casino and a utility under the same roof? That is the supposedly killer argument of those who want to bring back some variation of the Glass-Steagall Act. This US legislation, brought in during the Great Depression, banned commercial banks from underwriting securities – and led, among other things, to Morgan Stanley being spun off from JPMorgan. It was repealed in 1999.

The idea of forcibly separating utility banking from casino capitalism has superficial attractions. The utilities, which would be tightly regulated, would focus on taking deposits and lending money. The casinos, which would be lightly regulated, could take punts on a whole range of assets. Paul Volcker, head of President Barack Obama's Economic Recovery Advisory Board, advocated such separation on Friday at a conference at New York University's Stern School of Business.

But Glass-Steagall wouldn't have stopped the current crisis. For a start, many of the institutions that came a cropper weren't commercial banks. Lehman Brothers, Bear Stearns and Merrill Lynch were investment banks. American International Group is an insurer. All four caused havoc when they teetered on the brink – or, in Lehman's case, collapsed. The idea that any institution that is too big to fail, even if it is not in the utility end of banking, should be allowed to operate on a lightly regulated basis is surely wrong.

Now, of course, lots of commercial banks have got into trouble too. Think of Citigroup or, across the Atlantic, Royal Bank of Scotland or Switzerland's UBS. Part of the reason was that they invested in toxic securities. So it's appealing to think that they, at least, would have been safe if only they hadn't mingled the casino with the utility.

But this again oversimplifies the issue. True, these “universal” banks lost money in the casino. But they also lost pots of cash through straightforward bad lending. What’s more, there are plenty of other simple utility-like financial institutions that got into trouble: Fannie Mae, Freddie Mac, the UK’s Northern Rock, Countrywide, Washington Mutual and Wachovia. And going back a generation or so, there was the spectacular bankruptcy of the US savings and loans industry.

So, yes, the casino is risky. But so is the utility. What the current crisis has shown is that the management of risk has been woeful right across the board.

The solution therefore isn’t to pick on one particular banking activity – such as proprietary trading – label that as especially risky and quarantine it in some half-regulated purgatory. The better approach is to improve risk management across the industry.

Multiple changes are required to achieve this, including compensation systems that do not encourage bankers to run excessive risks. But an essential element also has to be a regulatory system - ideally, a simpler one than currently prevails in the US at least - that requires banks to hold fatter capital buffers the bigger the risks they run. That won’t just stop them going bust. Given that capital is expensive, it will also discourage them from running too many risks in the first place.

Such tighter regulation has to be the quid pro quo for being allowed to take deposits from the public or for being too big to fail. When banks take deposits, governments stand behind them with guarantees. If they are too big to fail, the taxpayer stands ready to bail them out. Whether they are commercial banks or investment banks is largely irrelevant.

There is, though, one dividing line that it is worth drawing: between institutions which enjoy the full panoply of government protection and those that don’t. Hedge funds and private equity

firms should fall into the latter category. They don’t themselves need to be tightly regulated.

Rather, the interface between them and banks needs to be closely monitored so that banks don’t extend them too much credit. If they go bust, they won’t then drag the banking system down with them. If some people think of that kind of divide as a new version of Glass-Steagall, so be it.

March 9 2009

Stock answers

By Dwight Cass

US financial watchdogs have short sellers in their sights once again. The Securities and Exchange Commission, under new boss Mary Schapiro, is mulling fresh curbs on short selling. Despite the political pressure for such moves, the regulator should reject ineffective measures.

The SEC board appeared refreshingly sceptical on Wednesday about rules intended to limit shorting. But the agency last September caved to pressure for a temporary ban on short sales of financial company stocks amidst the market carnage - a move since determined by at least one academic study to be both ineffective and disruptive.

Still, the watchdog did float new proposals. These are much less Draconian than an outright ban. The first involves variants of the uptick rule - the Depression-era regulation that prohibited short selling of a stock unless its last trade had been at a higher price than the one before. While intuitively helpful in damping a downward price spiral, SEC research determined this approach to be ineffective in practice - and the regulator repealed the old rule in 2007.

The second proposal envisions a circuit breaker that would ban short selling of a stock that had declined more than a predetermined amount.

Aside from the doubt about their usefulness, such rules can be costly. Studies have shown that the old uptick rule, for example, modestly inhibited market liquidity and price discovery. Rules that restrict short selling also weaken a natural market-based defence against manipulators who try to drive stock prices up and against fraudulent enterprises like Enron.

Moreover, they do little to restrain determined bearish schemers, since there are ways to synthetically short stocks in derivatives markets.

That's not to say regulators can't improve on existing rules and enforcement. After the SEC tightened its requirements for short sellers to pre-borrow shares last year, the number of failed trades - an indication of the level of illegal "naked" short selling - fell by some 40%.

But the worry is that political pressure and the SEC's desire to be seen to be "doing something" could still lead to bad policy. US accounting standard setters recently succumbed to similar pressure and weakened mark-to-market rules. The SEC needs to show stiffer resolve.

Context news: The US Securities and Exchange Commission held a public hearing on April 8 and released a set of proposed regulations covering short sales of equities on domestic exchanges. The regulator has asked for public comment within 60 days on two types of short sale restrictions: new versions of the uptick rule that regulators repealed in 2007; and a circuit breaker approach that would ban short sales if a stock fell by a predetermined amount in a given period.

April 8 2009

Fuzzy numbers

By Richard Beales

The imminent US backtrack on mark-to-market accounting is bad policy at a bad time. The Financial Accounting Standards Board's hurried rule changes for reporting financial asset values look like a rush job under bank-led political pressure. It will also confuse investors – the group supposed to benefit from accounting standards – at an already volatile moment.

Many politicians and pundits blame fair value accounting rules – also often called mark-to-market rules – for worsening the current crisis. Attaching distressed market values rather than a higher historical cost or long-term recovery value to financial assets, they say, has caused financial institutions' capital cushions, as reported to investors, to collapse – unnecessarily overstating the risk of insolvency.

But if a financial firm holds securities specifically for sale or in a liquid trading book, and funds itself partly or mainly with short-term borrowing, what do investors need to know? Pretty obviously, roughly what the securities would fetch if sold. Supporters of a fairly strict mark-to-market approach say its critics are blaming the messenger for problems of financial firms' own making.

Now FASB appears to be caving under political pressure, at least to a point. Its proposed rules would give financial companies' bosses and auditors more discretion to ignore actual market transactions as valuation benchmarks – instead using computer models or other methods to arrive at a value.

Public comments are due, perhaps fittingly, by April Fool's Day, with FASB's board set to meet the next day. The new rules, if approved, would apply to financial reports for the quarter ending on Tuesday. It's a measure of the proposals' popularity with many of those affected by markdowns on illiquid assets that

plenty of responses from financial firms actually suggest backdating the rules to the end of last year – even if that means restating accounts.

Some think differently. Goldman Sachs, for instance, has been a supporter of mark-to-market. Deutsche Bank, in its comments to FASB, said it didn't think the proposed changes would improve financial reporting or investor confidence, and highlighted inconsistencies and practical difficulties – not to mention the fact that they would widen the gap between US and international accounting standards, when convergence is supposed to be the objective. And the Securities Industry and Financial Markets Association warned of “unintended consequences”.

The timing, moreover, is troubling in three ways. First, its proximity to the grilling the FASB chairman received in Congress earlier this month; second, the short time given for discussion and debate; and finally, the possibility of financial institutions suddenly being able to paint a rosier picture of their balance sheets in the midst of an already volatile period. Overall it seems like a recipe for weakening, not boosting, investor confidence.

Context news: The US Financial Accounting Standards Board on March 17 issued proposals that, among other things, would provide “a framework for measuring fair value and a definition of fair value that contemplates an orderly transaction between market participants, not a forced or distressed sale.”

The move followed a hearing on March 12 in the US Congress when Robert Herz, the FASB chairman, was criticised by lawmakers for delaying proposals to modify mark-to-market rules. Public comments are due April 1, with the board due to consider the rules on April 2.

March 31 2009

Re-rating the raters

By Richard Beales

Governments are itching to heighten scrutiny of rating firms. European leaders last weekend signed up to the notion of mandatory registration and regulation for firms in the sector. But one problem in the past has been investors' over-reliance on officially sanctioned credit assessments. To set good rules, authorities everywhere should first consider why they need ratings.

Many governments see them as something like crash test ratings for cars. An investment grade rating is supposed to imply reasonable protection even in a bad market pile-up. Regulators tend to encourage vulnerable citizen-investors to travel in such vehicles. Central banks also use ratings for their own purposes, for instance in setting terms for collateralised lending.

Watchdogs, meanwhile, use them to help decide how much capital banks need to hold against credit-related assets. Having said that, Basel II bank capital rules were moving away from reliance on external ratings, at least for big banks – and now, the whole philosophy of capital adequacy is up for grabs again anyway.

Even in the investing arena, ratings have only limited application. They primarily assess default risk, not saleability or market price – both very important to most investors. But some investors have relied on ratings for comfort in these areas as well, partly because they are officially blessed.

Another problem with the badge of approval given to ratings is that they have become widely used in lending agreements as triggers. That leads to the spectacle of companies like American International Group, the recipient of massive government bailouts, desperately trying to retain an already

credulity-straining single-A rating for fear of further huge collateral calls and cross-defaults.

Then there's the well-known potential conflict that stems from ratings being paid for, in many cases, by borrowers rather than investors. And while old-fashioned corporate ratings have for the most part served investors reasonably well over the years, rating firms have suffered an almost complete loss of credibility with their structured finance ratings over recent months.

All these problems would be lessened or eliminated if investors, lenders and governments had to do their own analysis, drawing on – and paying for – the best research available competitively in the market along the way, without the crutch of officially-sanctioned ratings.

Unfortunately, ratings are entrenched in laws and regulations and, with heavier-handed regulation the order of the day, politicians seem determined to leave them so. To minimize further damage from flawed ratings – and to avoid inflicting fresh pain from bad regulation – financial policymakers need, at the very least, to focus their efforts.

They should, for instance, think in terms of a global approach and common standards for an essentially global fixed income market. Happily, they appear to be doing so.

They should also make sure credit crash tests are done right by ensuring ratings firms arrive at ratings sensibly, thoroughly and consistently and aren't conflicted. Recognized rating firms should also be required to have complete information and to disclose enough of it for anyone else to duplicate the tests, too.

Ratings should also carry clear caveats. Drivers of five-star rated cars still crash if they don't drive carefully, and they still get hurt. Investors should be reminded what ratings measure, and warned to do their own research as well. Highlighting the

relative volatility and subjectivity of structured finance ratings might have prevented a few disasters.

Finally, rating firms should be held accountable. A government seal of approval is a valuable asset. In return, recognized rating organizations should forego the conceit that they are just dispensing opinions, with no redress if they screw up. If they mess up on process, conflicts or disclosure, they should be subject to loss of status, appropriately sized damages or fines big enough to hurt.

None of this is as clean as removing official recognition of ratings. It won't prevent some investors continuing to rely on them too heavily, and nothing will stop ratings occasionally proving spectacularly wrong. But if governments can focus on what matters, at least they won't be distracting investors too much as they try to navigate financial markets.

February 24 2009

Chapter 8

Personal views

Up to now, all the articles in this book have been “house views”. But our editors and journalists sometimes present ideas that have don’t gain consensus within Breakingviews.com – let alone in the wider world.

Here are two such ideas:

- New financial products should be tested before being launched on the public – in the same way that a new drug is put through its paces to make sure it doesn’t have terrible side-effects.
- Bank leverage should be controlled by comparing capital to revenues.

Testing times

By Edward Hadas

Imagine this speech from a pharmaceutical marketing manager. “This new drug is designed to work well, but we haven’t tried it out yet on real people. Of course, there could be terrible side effects, but wait and see. One thing’s for sure, though. There’s money in it for our company”.

Regulators try to make sure drug makers don’t work that way. But it’s still pretty much standard practice in finance. During the credit boom, banks raced to create products with good margins but no clear economic purpose – and high risks for buyers and the whole financial world. Regulators mostly stood by idly.

It’s time for a change. Tough standards for individual product certification should be part of the financial regulators’ plan to establish a safer and sounder global banking system. The mantra in pharmaceutical regulation is “safe and effective”. That’s a good approach for finance too.

Safety in finance doesn’t mean “no losses”. Rather, high-risk products shouldn’t get in the wrong hands. Regulators have long realised this. That’s why small retail investors can’t buy hedge funds. But many complex products - especially those that involve high leverage - should fail the risk-reward safety test for any investors.

Regulators should also look at group safety. One credit default swap isn’t dangerous, but an uncontrolled CDS market that is bigger than the world’s GDP is structurally unsafe.

Of course, banks and rating agencies have always done their own product safety tests for financial products. But they have consistently been too optimistic. Commercial considerations seem to have led the industry’s in-house testers to

underestimate the probability of – and danger from – extreme events. Regulators should be much tougher.

It isn't always easy to say what financial products are effective. Great claims were made about the ability of securitisations to spread risk more efficiently, but the benefits were exaggerated. Similarly, credit insurance was supposed to give lenders more confidence, but many of the suppliers of this insurance – such as the monolines and American International Group – offered more supposed protection than they could afford.

All the basic financial products have been proven in the test of time. Bonds, shares and old-fashioned banking and insurance did a good job at building a global industrial economy. Some newer developments in futures and derivatives could join the list. But the existing products already do what finance is supposed to do – gather and allocate capital, amortise risks, provide fair returns. In finance, much of what is new is likely to be snake oil.

So regulators should be sceptical about claims that the latest proposed artefact of financial engineering has economic value – especially any financial widgets which are highly profitable for the producer or which allow buyers to put up less capital.

Financial regulators should borrow some tricks from their pharmaceutical peers. Animal trials are out – rats can't buy collateralised loan obligations. But new products should be tested on small groups of customers. And approval should always be tentative. Design flaws sometimes only emerge over time. If there are faults, the products should be scrapped or re-engineered with better safeguards. When it comes to stopping financial excess, it's better to be a little late than to wait for disaster.

April 21 2009

Ratio gaga

By Jeffrey Goldfarb

How do you make sure banks don't borrow too much? Control leverage is the seemingly obvious answer. So obvious, indeed, that the G20 looks set to advocate it be part of financial regulatory schemes. The UK's Turner Report has just taken a similar line. Switzerland has, for its part, also recently decided on this course of action.

But the leverage ratio is an over-simplistic measure that doesn't capture risk especially well. Admittedly, none of the authorities are advocating junking the standard Tier 1 capital ratio and relying just on leverage. They see leverage as a backstop to be used in conjunction with the Tier 1 ratio. But there is an alternative and potentially better adjunct to gauge a bank's strength: look at its capital as a percentage of revenue.

The enthusiasm for ensuring that banks are limited in how much they can leverage up their capital is a reaction to boom-time borrowing levels. Canada had such a control mechanism during the good times – forcing banks to keep their leverage ratios below 20. It believes this helped its banks avoid many of the excesses that bedevilled banks in other countries. The world's top 50 banks, on average, leveraged their Tier 1 capital 25 times before the crisis. In some cases, it was 50 times.

The simplicity of a leverage ratio is its primary allure. The Tier 1 capital ratio, by contrast, is exceedingly complex. The process of assigning risk weightings to assets is tedious and opaque. A leverage ratio can be calculated and understood more simply by all manner of stakeholders. Analysts and regulators might disagree on which measure of capital to use in the ratio – tangible common equity, book value or even Tier 1 capital – but they are all equally accessible.

The ratio's simplicity, however, also happens to be its shortcoming. By using total assets instead of risk-weighted assets, a safe Treasury bill and a risky collateralised debt obligation wind up getting equal treatment. To improve its leverage ratio, a bank could be tempted to stuff more risk into fewer assets while at the same time shrinking its balance sheet by walking away from high-volume, low-risk lines of business.

In contrast to the success of Canada's banks in navigating the crisis, US banks have suffered many failures. Most US bank holding companies – but not the old broker-dealers like Lehman Brothers – are required to keep their leverage ratios below 25 though the strongest among them can go up to 33. But that didn't help. European banks, which had no such constraint, didn't suffer bigger write-downs, according to an analysis conducted by Bernstein Research.

A better way?

But there is a way to bridge the knottiness of the Tier 1 capital ratio and the bluntness of the leverage ratio. Look instead at the bank's capital divided by its revenue. This "revenue ratio" is just as easy to calculate as the leverage ratio yet it has the advantage of capturing more elements of risk.

Higher revenue at a bank usually – though not always – reflects higher risk. Banks generally try to balance risk and reward even if many of them failed in recent efforts. Big jumps in revenue are more apt to reflect the additional risk than piling on assets is.

A revenue ratio has the added advantage of capturing off-balance-sheet operations, which are typically lost in a measure that relies on assets. It's also harder to game the regulatory regime with a revenue ratio. What kind of bank would manage down its revenue?

A cursory glance at 15 large banks' revenue ratios – using tangible book value as the measure of capital – at the end of

2006 is suggestive but not conclusive. Strong survivors of the crisis – BNP Paribas, Santander and JPMorgan – had three of the four highest revenue ratios, at 160%, 147% and 106% respectively. The other member of the top four – Unicredit, with a ratio of 130% - has been a poor performer but not a calamity.

Now look at the bottom four. That list contains Royal Bank of Scotland and UBS – two of the biggest losers – each with a revenue ratio of 79%. On the other hand, Goldman Sachs and Barclays – neither of which has been a disaster – had even lower ratios, at 78% and 63%.

A more comprehensive study of all three ratios – Tier 1 capital, leverage and revenue – was conducted in 2000 by a team at the Federal Reserve Bank of New York. After looking at every bank covered by the US Federal Deposit Insurance Corporation over several years, they found that while the Tier 1 capital ratio was the more effective in anticipating collapses in the long term, it was not more consistently predictive than the two simpler measures over a one-to-two-year horizon.

When all three ratios were analysed in conjunction with one another, the revenue ratio seemed to be the most useful. The economists speculated that was down to the fact that it includes elements from both the income statement and the balance sheet.

The evidence looks sufficient for the revenue ratio to be given further consideration before the world's banking regulators rush headlong to enforce a leverage ratio.

Context news: The G20 working group on financial regulation has recommended that the Tier 1 capital ratio be supplemented "with simple measures to contain the build-up of leverage."

Lord Turner, chairman of the UK's Financial Services Authority, said in his March report proposing a regulatory response to the global banking crisis: "The FSA's analysis indicates that there is

a role for a leverage ratio to complement a revised strengthened framework for risk-based capital.”

Philipp Hildebrand, vice-chairman of the Swiss National Bank, said in a speech last December: “To enhance the longer-term resilience of the financial system, effective regulation to curtail banks’ leverage is required.”

Mark Carney, governor of the Bank of Canada, said in a speech last November: “While Canada’s financial system has been affected by the crisis in global financial markets, the impact has been significantly less than in many other major economies ... Not merely have losses on structured products of Canadian banks been modest, but more importantly, their absolute leverage is markedly lower.”

March 25 2009

Epilogue

Smaller, duller, safer and less lucrative

The new regulatory regime will cause dramatic changes in the world of finance. That much is clear even before the final details are filled in.

The requirement to hold more capital, for example, means banks will earn lower returns on equity. They won't just be able to leverage themselves up to the gills and hope for the best. The same goes for telling banks to have more liquid assets. It won't be so easy to play the game of borrowing cheap short-term money and stuffing it into illiquid long-term assets. Measures to crack down on excessive risk-taking will also cut profits – at least in the good times.

With lower profitability, finance will no longer be the money-pot which sucks in talent from all across the world. Add that to restrictions designed to align compensation with long-term achievement and Wall Street and the City will no longer be such an easy way to get rich quick. Smart graduates will be more tempted to go into industry or the professions. That will be healthy.

All in all, the new regulatory compact is likely to make the post-crisis financial world a safer, duller and less lucrative place. After the roller-coaster of the last few years, that is no bad thing.

Further reading

1. [G20: The Global Plan for Recovery and Reform](http://www.g20.org/Documents/final-communicue.pdf)
<http://www.g20.org/Documents/final-communicue.pdf>
2. [G20: Declaration on Strengthening the Financial System](http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_02_0409_-_1615_final.pdf)
http://www.g20.org/Documents/Fin_Deps_Fin_Reg_Annex_02_0409_-_1615_final.pdf
3. [FSF: Addressing Pro-cyclicality in the Financial System](http://www.fsforum.org/publications/r_0904a.pdf)
http://www.fsforum.org/publications/r_0904a.pdf
4. [FSF: Principles for Sound Compensation Practices](http://www.fsforum.org/publications/r_0904b.pdf)
http://www.fsforum.org/publications/r_0904b.pdf
5. [Zhou Xiaochuan: Reform the International Monetary System](http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178)
<http://www.pbc.gov.cn/english/detail.asp?col=6500&id=178>
6. [US Treasury: Framework For Regulatory Reform](http://www.ustreas.gov/press/releases/tg72.htm)
<http://www.ustreas.gov/press/releases/tg72.htm>
7. [FSA: The Turner Review](http://www.fsa.gov.uk/pubs/other/turner_review.pdf)
http://www.fsa.gov.uk/pubs/other/turner_review.pdf
8. [The de Larosière Report](http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf)
http://ec.europa.eu/commission_barroso/president/pdf/statement_20090225_en.pdf
9. [FASB: Proposals to Improve Guidance on Fair Value Measurements and Impairments](http://www.fasb.org/news/nr031709.shtml)
<http://www.fasb.org/news/nr031709.shtml>
10. [Breakingviews.com's recommendations of the best financial history books](http://www.breakingviews.com/2008/04/02/Financial%20history%20books.aspx)
<http://www.breakingviews.com/2008/04/02/Financial%20history%20books.aspx>

About us

Breakingviews.com is the world's leading source of agenda-setting financial insight. Breakingviews.com has 22 correspondents and columnists based in London, New York, Paris, Washington, San Francisco, Hong Kong and Madrid.

Our real-time subscription service currently reaches around 15,000 financial professionals such as investment bankers, senior corporate executives, hedge fund managers, lawyers and private equity professionals. We reach a broader audience of nearly 4.5m investors and opinion-formers via columns in the following influential newspapers: The New York Times (USA), The Telegraph (UK), The International Herald Tribune, CNNMoney.com (USA), Nikkei Veritas (Japan), El Pais and Cinco Dias (Spain), Handelsblatt (Germany), La Stampa (Italy), NRC Handelsblad (Netherlands), The National (UAE), The Business Times (Singapore), The Business Standard (India) and L'Agefi (Switzerland).

About Alvarez & Marsal

For more than 25 years, Alvarez & Marsal has set the standard for solving complex business problems, improving performance and maximizing value for stakeholders. Whether serving as advisers or in interim management roles, Alvarez & Marsal draws on its deep operational heritage and hands-on approach to deliver operational performance improvement, turnaround management and business advisory services that produce sustainable results. Clients range from global enterprises to middle market companies that are publicly-held as well as privately-owned. The firm's multi-disciplinary and multi-cultural professionals work with company management, boards, and private equity owners with portfolio companies that span the industry spectrum. With 1,600 people in nearly 40 locations worldwide, Alvarez & Marsal professionals bring a bias towards action and results. The firm was recently recognized by Consulting Magazine as one of the Top Ten Best Firms to Work For and ranks in the top 50 consulting firms by the Vault.

For information, visit www.alvarezandmarsal.com.