Will corporates be the collateral victims of financial regulation?

Both in the US and on this side of the Atlantic Ocean, politicians are going out of their way to prove to their electorate that they have learnt the lessons from the financial crisis and that it would never happen again (in this way…).

Now that they have taken a number of measures which are completely unfocused, overly timid or pointless (fiscal shelters, traders' bonuses, supervision of financial systems or rating agencies) they might well end up achieving the exact opposite of what they should have been after (regulation of derivatives and reshaping of Basel II), had they been serious about preventing another financial crisis in the years to come.

Let's put this straight: The action of small states whose survival depends on their ability to attract monies from abroad has certainly not been at the origin of the financial crisis, nor has it compounded its effect. But our politicians gladly availed themselves of the opportunity to lure back some funds that escaped taxation at home. Some of these monies will be used to finance the recovery of the banking system…fair enough? Some may say so and part of their electorate may rejoice. Still, as this was obviously considered to be the most urgent political priority, one might have wondered about the consistency of the steps to come, and rightly so….

Because, what came next? In search of a culprit to point a finger at, our politicians thought credit rating agencies would do nicely as scapegoats. You may indeed wonder why some special purpose vehicles, filled with junk mortgage loans, were rated as if they were riskless…..despite extremely juicy returns offered to investors. Common sense should have prevented investing in such opaque instruments, not bad ratings! This being said, the real issue is an evident conflict of interest rather than credit rating agencies using a flawed methodology - it is very difficult to seriously challenge the intrinsic quality of analysts, and opening the profession to further competition may well result in worsening the quality of the overall output. Actually, the real issue is the business model itself, whereby the issuer pays the rating agency for issuing an "opinion" on the likelihood of the debtor to default. The expertise should be paid for by the investor and not by the issuer - but although this is visible to the naked eye, nobody seemed to care. Instead, registration, supervision and check of methodology were chosen as the easy way out. Alas, powerful financial institutions will invariably be in a favourable position to press a rating agency to accept "a slightly different approach to risk for this specific asset", particularly if there are new entrants that will have to fight to find their place in the picture….and here we go again. Your suggestion is not feasible, I hear you say; how would the rating agencies collect fees from millions of individual investors? This is a tricky question, admittedly, but dodging it is a major mistake. I remember a situation in the late 80's when holders of petrodollars founded IBCA in London and hired analysts from banks and rating agencies to give them advice. The clients were the shareholders. Where there is a will there is a way, provided you really want to look for it.

Now, what about a more stringent, fitter and more resilient supervision of the financial markets? Dream on… National supervisors that clearly failed to recognise the crisis to come - or worse, did not dare alert the authorities - are still fighting to resist a properly organised oversight which would have to operate at European level, at least. Financial markets do not recognise national boundaries or sector separation: the bank insurance model that allows shifting risks from one activity to another

around the globe within seconds should be supervised by a common institution to banking and insurance. Well, nothing has been achieved at all in that direction. Fragmentation of oversight is still there, because of fiscal sovereignty, they say. All of this is highly unwise; these national contraptions will not survive the next bubble, and tax payers will soon have to come to the rescue of the financial sector again.

The last proof of the poor performance of our politicians in trying to take action to prevent the next serious crisis is the way in which traders' bonuses are handled; what we see is once again fiddling with symptoms rather than curing the underlying disease. Traders are instructed to generate short term profit (and are rewarded accordingly, which is fair enough). Do not blame the traders; blame the institutions for fuelling unsustainable growth and faking wealth, and perhaps also the greedy shareholders that expect management to deliver 20% ROE year on year on year…. but hang on, who are these shareholders? Isn't it us, the tax payers, in this day and age?

Well, let's relax and wait for the next financial crises, which hopefully will come quickly enough to prevent oblivion, because you can't get rid of greed, can you (Mahatma Gandhi said that there is enough on earth for everybody's needs but not for everybody's greed…).

But before we get there there is worse to come. As if it were not enough that our politicians are incapable of taking bold measures - now they are missing the target even more by planning to regulate the derivatives market through a "one size fits all" approach. Credit Derivative Swaps (CDS) have indeed fuelled the crisis; you may wonder whether this would have been as dramatic had the US administration prevented Lehman from going bust, but that is a moot point. The CDS market is an opaque one and ought to be reorganised, without any doubt. The equity linked swaps market could probably also do with a serious clean-up. But can anyone please tell me how you would reduce systemic risks by pushing the foreign exchange, the interest rate and the commodities markets (the only markets used by corporates to hedge their risks) towards a central clearing counterpart (CCP) model or towards exchanges? One might even argue that creating a single point of failure will increase the risk; you will be hard put to find any convincing evidence in literature. Once again it is not the instrument as such that creates a risk but the way you use it. Corporates have never used CDSs and equity linked derivatives: only banks and hedge funds did. By concentrating the risks you might well trigger a number of additional unintended effects as a consequence of corporates changing their attitude towards risk management; let me explain. Banks will be incentivised (through capital adequacy rules) to go towards CCP and exchanges to clear the derivative business; they will pass on the initial costs of change to the users of all derivatives, thus including users of forex, interest rates and commodities instruments. Additionally, as banks will have to post collateral with CCPs and exchanges as well as margining, they will have to extend additional credit lines to their corporate customers to reflect the cost of their collateral/margins; but will they do so? Their appetite for corporate lending has been shrinking continuously for years. More subtly: The incentives given to banks to use CCPs and exchanges will push for standardised contracts and will induce the disappearance of an effective OTC market (bilateral market) which corporates need to hedge non standard positions and qualify for hedge accounting. This leaves the corporate customer who needs to cover his risks - non standard by definition as it is derived from his normal industrial activity - with an additional problem: Hedging will not only be more expensive but will become dependent on the management of an additional risk which is the liquidity risk! Although some say that corporates are not good at managing their counterparty risks, they will most certainly be even

worse at managing liquidity risk as this is not within their reach. Who can force an unwilling bank to extend additional credit lines unless you pay a significant premium for them? Corporates have no access to central bank monies. And now we come to the real dilemma: If the hedge of an exposure does not qualify for hedge accounting to offset the risk from P/L; if hedging is additionally more complex (margining) and expensive….then corporates may well decide to keep more risks in their books, particularly SMEs, increasing by so doing the volatility of the accounts. A carve out of some sort is thus absolutely necessary to avoid a huge step back in risk management processes in the corporate world.

Not to finish on too desperate a note: Hopefully we can rely on the wisdom of the Basel Committee to make sure that the revised rules do not miss the target as well by penalising the corporates. There is no doubt that procyclicality has to be stopped. Spain was very proud of the anticyclical measures which the financial regulator had successfully imposed upon the Spanish banks for many years. Although this did not prevent the housing bubble, their banks were obviously more resilient to absorb the shock than those in other European countries. Sadly though, these anticyclical measures will discourage banks from entering into longer term commitments with their customers. Will this be yet another unintended consequence? The bottom line is that corporates will end up footing the bill for wrongdoers.

Olivier Brissaud *

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