

“L’État, c’est moi” makes the system go pop

“Après moi, le déluge”. So it was once attributed to Louis XV, the Bourbon ruler of France who reigned in the twilight years of l’ancien régime. Whatever the historicity of that quote, the sentiment was ultimately correct for, as it happened, the sixteenth Louis (who had followed the fifteenth Louis), was himself and his régime marched out of the halls of Versailles and to the guillotine to the mob’s piercing cries. The France that had suffered through decades of economic and social stagnation finally found relief and a change of sorts. The momentary end of the Bourbons broke open the figurative dam of radical and often violent political experimentation, the reverberations of which carried forward for decades (maybe centuries) thereafter. Tumult is no prisoner of the past, as we have seen in recent days with bursting financial bubbles.

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These too have always been the inevitable result of popular delusions and the madness of crowds. In our modern day, we have bore witness to a technology bubble, a real-estate bubble, a commodity bubble, the numerous bubbles arising from various emerging markets and finally, the mother of all bubbles, that of the unrestrained extension of credit and the misallocation of risk. Now we brace ourselves for the deluge, the bubble of financial regulation and oversight certain to be broad and sweeping.

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The thought of more regulation ought to give us as much pause as less. Just as the reforms of the early French Republic brought on considerable unintended consequences, so too will regulations dreamed up by politicians and academics in theoretical and similarly dubious environments. Experience from Sarbanes-Oxley, a previous set of financial reforms brought on by a deluge of accounting scandals, has shown its many unintended effects – most notably that of chasing many companies out of the public markets and away from important sources of capital and liquidity. It is worth considering what other regulations may have contributed to our situation.

Two observations come to mind – both of which bear allusions to schoolroom physics. For the first, consider that the strength of materials is often a multidimensional task. Attempting to make, say, some mix of concrete stronger through some new method may succeed in its limited task, but at the cost of making the material

more brittle. This concrete may be able to withstand greater pressure under normal conditions, but be more willing to break catastrophically when confronted with a sufficiently great force. While this may sometimes be a property that can be lived with, more often engineers recognize that robust systems must be able to bend to avoid the possibility of breakage.

Financial institutions are inherently closer to being brittle concrete than bendable steel, relying as they do on confidence of lenders or depositors to keep them solvent. Once they lose that confidence, which is what happens in a financial crisis, the tendency is towards breakage. There is no escape for a financial institution that declares bankruptcy – they cannot reorganize, but must rather liquidate. While depository insurance (like FDIC) reduces this brittleness to some extent, it is troubling to note considerable circumstances in which measures that have intended to strengthen our financial system have also served to make it more brittle.

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When Lehman Brothers fell in mid-September, not only did it spell the end of its existence as an entity, it explicitly revoked what had been the implicit assumption that it would not fail, because it was too big to do so, thereby revoking it for all other banks as well, and making them all riskier than the market value of their debt securities had until then reflected. Leverage being these institutions' lifeblood, this gross devaluation squeezed their business model and their threatened solvency. Further, mark-to-market rules fed into another negative feedback loop of progressively declining asset values, feeding into falling transparency and confidence in the system. As accounting rules virtually forced the zeroing out even of assets that had continuing cash-flows, the market became unhinged from valuations and a crash in confidence fed into a system-wide run on banks occurred, with investment banks unable to borrow money from each other. The brittleness of the system was almost its undoing.

Or take, for instance, the saga of the bond insurers, Ambac and MBIA. These two institutions ran a lucrative business of lending out their sterling 'AAA' ratings by issuing insurance on fixed income securities. This was a valuable service since the investment grade rating that municipals and structured products received as a result of the insurance made them eligible to be held by many pension and other government investment funds. There was a sizable risks in this: as the very business of these firms were predicated on having the sterling credit rating, a downgrade in extraordinary times

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would have cascade effects, progressively eroding their financial position and theirs and their policyholder's creditworthiness along with it. This is exactly the phenomenon that occurred earlier this year... Once the many otherwise pedestrian munis or structured products no longer had the investment grade ratings of their insurers, they had to be dumped from the many portfolios that held them, causing their market values to crash. As these insurers' share prices reflect, they were less bendable and more breakable.

Rules that governed the allocation and assessment of risky assets made this more brittle than it ought to be. Consider further that a plethora of rules exist that require virtually all fixed income securities to go through one of a very small group of rating agencies before they can be held by many institutions. Although intended to make risk more transparent to the market, it has accomplished this only by narrowing options and increasing moral hazard. Or consider rules that institutionalize quantitative portfolio management as it was theorized decades ago, despite well known defects to the process. While seemingly strengthening our markets, they hide risk, only to find it back with a vengeance later – brittle, not strong.

Which bring us to the second schoolroom physics lesson – that the path of least resistance is always taken. So true is this when the financial markets are concerned. Create an arbitrage opportunity, and money will find its way through it. Gum up an established channel, and money will find its way around it. Securitizations, structured investment vehicles and other products of the shadow banking system thrived in a wilderness of regulations that forced capital into ever more creative off-balance sheet accounts and structures.

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Consider, for instance, FDIC rules implementing the various international agreements on risk management, particularly those rules that arbitrarily assign risk rates to different forms of debt and, by extension, the collateral requirements of the debt. Under these rules, if you originate a mortgage with a 20% down payment, the risk weight associated with the loan is 35%. If, however, you repackage the mortgage as an 'AA' or 'AAA' rated security, all of a sudden, the risk weight is 20%, even though the underlying investment has not changed and the package it is in has gotten more opaque, not less. Given this and many other arbitrary requirements, it bears wondering to what extent securitization activity has been little more than a practice in regulatory arbitrage.



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What hath we wrought and how do we get out of this? Neither the “risk-free” financial fad of the day or implicit hidden government guarantees will make risk disappear; they merely delay paying the piper for another day. International treaties and government institutions that tell us how to manage risk will fail when market conditions and the newest techniques of fast-moving organizations change faster than they do. It is high time we put the pricing of risk back where it belongs, in the hands of those who bear it, and stop believing that yet another layer of regulations that purport to reduce, manage, outsource, and hedge it away, will do it for us.

Markets favor transparency and sound valuation, and we believe that a free market of best practices that make our financial system robust, (not brittle), transparent, (not opaque), is best. To that end, equal opportunity to access capital, free from arbitrary bureaucratic standards, will make us all better off and bring the world together.

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