Featured commentary by Satyajit Das

Regulatory Debauchery

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Lenin is said to have declared that the best way to destroy the capitalist system was to debauch the currency. Debauching the regulatory apparatus is a step along the same road.

Current problems in credit markets are attributable, in part, to failures on the part of central banks and regulators. The response to the credit crisis also contains fundamental deficiencies.

The "Greenspan" Put

Central bankers fueled the liquidity bubble through excessive monetary growth and low interest rates. The "Greenspan Put" repeatedly bailed out banks and investors from poor decisions or irrational exuberance underwriting excessive risk taking. Asset price bubbles rolled merrily along; waves of risk mis-pricing moving through different markets. The current credit crisis has its origins in the Federal Reserve's interest rate cuts of the early 2000s that helped engineer the housing bubble. This enabled the markets and economy to recover from the Internet bubble.

Bank regulators have presided over substantive changes in financial institution balance sheets and risks. The balance sheet of large banks and investment banks now hold high levels of risky and illiquid assets, such as private-equity investments, bridge loans, hedge funds investments, distressed debt and exotic derivatives. Derivative transactions with and loans to hedge funds through their prime broking operations are substantial. Assets and exposures in "arbitrage" conduit vehicles, structured investment vehicles ("SIVs") and hedge funds outside regulated bank balance sheets have increased. A recent OECD analysis shows that while major banks have increased capital and reduced reliance on short-term funding the risks have increased faster.

Regulators have been uncritically accepting of financial innovation. The benefit of dispersion of risk through the final system has become the accepted orthodoxy. The risks of a diffuse, opaque, globally inter-linked, highly leveraged financial system have largely been ignored. Belatedly, in its 2007 annual report, the Bank of International Settlements ("BIS") admitted that "*our understanding of economic processes may be even less today than it was in the past*".

As recent events show the risk transfer is largely cosmetic. In excess of $300 billion of risk in the form of Asset backed Commercial paper ("ABS CP") - short term IOUs secured against high grade (AAA/AA rated) securities including CDOs ("Collateralised Debt Obligations") – has returned to bank balance sheets as ABS CP investors have gone on a buyer's strike.

Financial institutions have already incurred losses of over US$ 50 billion. A substantial volume of assets is likely to return onto bank balance sheets as off-balance sheet structures and hedge funds are forced to sell. For examples, HSBC has announced that it will bring around US$ 45 billion of assets from two SIVs *de facto* back on balance sheet. The total amount that will be re-intermediated by banks may be in the range of US$ 1 to 2 trillion. Weaker banks have been forced to forage down the back of the sofa for any loose change to add to their dwindling liquidity to meet these commitments. This has led to sharp rises in inter-bank lending and borrowing rates as well as general shortage of funds, especially for riskier borrowers.

Mean reversion

Central banks have reverted to type in dealing with the crisis. There is no difference between a run on a bank and shutdown of access to funding from the capital markets. US mortgage lenders have faced old-fashioned runs. Northern Rock found itself requiring central bank support (in excess of £20 billion (US$ 40 billion)) as it was unable to raise required funding in money markets. The Chancellor of the UK Exchequer was forced to effectively guarantee the UK system of

bank deposits to restore confidence Central banks, including the Fed and European Central Bank ("ECB"), have pumped money into the system in an effort to ease the liquidity crunch.

In further regulatory debauchery, the Fed recently allowed banks to pledge ABS CP as well as highly rated asset-backed securities, corporate bonds and mortgage-backed instruments as collateral for funding at the discount window. Funding has been extended from overnight to 30 days. Other central banks have followed suit.

Traditionally, only government securities are eligible for discounting. A fundamental principal of the discount window is that it is designed to provide *short-term liquidity against instruments of unimpeachable credit quality*. The regulatory spin is that this is "temporary" "in the light of market conditions" and "recognises innovation in the market".

There are profound practical and policy issues in this development. What price will the central banks attribute to these riskier securities? What is the level of the advance that the central bank will offer and how will this be adjusted as market values of the underlying collateral changes? There are unconfirmed suggestions that the central banks are placing a value of 85% on AAA CDO securities. Given that there is significant uncertainty about the value of the security and even how they should be valued, the entry into this debate by central banks is curious.

There is also the question what happens if the bank cannot redeem the borrowing at the end of the 30 days and the value of the securities is below the level of the amount advance. This is precisely the problem confronting lenders who have lent against these securities. Central banks appear to have entered the field of prime broking, perhaps tempted by the profitability. In widening the eligible assets, central banks are effectively underwriting the *credit risk* and the *liquidity* of the financial system with public money.

The moves have also done little to ease liquidity or credit market concerns. Following the cut in the discount rate, four major US banks used the discount window: "*to encourage its use by other financial institutions*". They did not need cash. It was a sign of strength. In the words of financial historian, Charles Geisst, it was : "*like someone from the Upper East Side being seen in .. Wal-Mart*".

In other cases of "déjà vu all over again", there have been suggestions that Fannie Mae and Ginnie Mae step in to buy mortgages to support liquidity as they have done in past crisis. The two institutions have assets and guarantees of almost US$4.0 trillion supported by stockholders' equity of around US$60 billion. Both entities have also reported recent losses and have been forced to raise capital. The scope for liquidity creation by this route is likely to be difficult.

Socialism for Wall Street

In good times, financial markets embrace Capitalism. In bad times, financial markets re-discover Socialism. Currently, the US Federal Reserve is engaged in a dangerous strategy to look after its Wall Street friends.

The Fed has cut the fed funds and discount rates. The markets cheered the Fed decision to cut rates in September and then again in October. "*This is manna. I am blown away. These guys get it I could hug these guys. This is what we wanted*." Jim Cramer, CNBC's markets pundit, was at the forefront of the cheerleading. Since the Fed's interest rate cuts, equity markets have reached records levels and the junk debt has recovered modestly.

Relief has been short lived. In recent weeks, the differential between inter-bank rates and the central bank targeted rates has widened to levels not seen since August. This points to further potential cuts in both rates by the end of the year. Lower cuts are inconsistent with above target inflation levels resulting from high oil prices, higher food prices, increasing cost pressures in emerging economies such as China and the potential inflationary effect of a weaker US dollar.

The US central bank's strategy is clear. The current credit problems require a substantial reduction in the level of borrowings and leverage in the global financial system. Asset prices ramped up by excessive debt need to adjust. The adjustment can take place via a "crash". This would be de-stabilizing and would wreak further havoc on already weakened banks. Alternatively, the de-leveraging and price adjustment can be achieved by creating inflation through loose monetary policy. If asset prices remain at current levels, higher inflation allows values to fall in real terms. Higher inflation also reduces the value of the borrowings that must be paid back allowing the required reduction in leverage.

Between January 1960 and December 1974, the Dow Jones Industrial Average was substantially unchanged. This is despite significant periodic rallies during the "go-go years". If inflation averaged 5% pa, then the value of the market (ignoring dividends) lost around half (50%) of its value in real (inflation adjusted) terms.

The Fed strategy also assists affected banks. The large writedowns in risky assets and the expected re-intermediation of assets means that some banks need large infusions of capital. Given recent performance and subdued profit outlook, it would be difficult for them to raise this capital at acceptable prices.

Lower short-term interest rates allow banks to borrow cheaply. The money can be used to purchase government bonds that provide higher returns than the cost of borrowing. This generates profits for the bank without the banks having to hold capital against their assets (banks generally are not required to hold capital against government securities). The profits help re-capitalize the bank. An added benefit is that the US government can fund its deficit by selling its debt to the banks. This would be handy if foreign demand for US Treasuries decreases in response to the weaker dollar.

In the 1980s, US manufacturers looked to Japan as the source of ideas to improve efficiency. Remember "Just-in-Time" manufacturing, "zero defect" etc. Now, it seems US regulators are borrowing ideas from their Japanese colleagues. The Bank of Japan used the same strategy to re-capitalize the loss making Japanese banks after the collapse of the "bubble economy" in 1989.

Higher inflation expectations are already evident in higher gold prices, the steeper US yield curve (long term rates are higher than short-term rates) and the weaker US dollar. Foreign investors, especially large sovereign investment funds, are switching from financial assets (bonds) to "real" assets (companies with real businesses) reflecting higher inflationary expectations.

The strategy is dangerous. Inflation can lead to a significant transfer of wealth from investors to borrowers. Inflation once embedded in the economy distorts economic activity such as investment and savings. The experience of the late 1970s and early 1980s highlights the difficulties in recapturing the inflation beast once uncaged. Paul Volcker, then Chairman of the Federal Reserve, bravely increased interest rates to stratospheric levels to squeeze inflation out of the financial system.

The strategy may also not work. The cuts in rates do not appear to have had the desired effect in improving market liquidity conditions. Default risk concerns continue to inhibit lending and other routine financial transactions. Lower rates may set off further bubbles – for example, in equities and emerging markets. Asset prices may fall sharply anyway. In fairness to Dr. Bernanke, he has limited policy alternatives available.

Central bankers have stated that "errant" banks and investors will not be "bailed out". Actual actions suggest otherwise. Banks have played their "nuclear" option well. The specter of "systemic risk" – whether real or not - is one a central banker cannot ignore. The banks continue to privatize gains and socialize losses.

These moves have attracted remarkably little scrutiny or comment. Central banks are effectively underwriting the *credit risk* and the *liquidity* of the financial system with public money but without any transparent political debate. Socialism for Wall Street prevails, once again.

Central banks and regulators bear a serious responsibility for safeguarding the functioning and integrity of financial systems. At the moment they are being exposed like the Wizard of Oz – old desperate men (they are mainly men) behind the curtain running from one lever to another in a desperate attempt to maintain illusions.

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[1] See Adrian Blundell-Wignall (2007) An Overview of Hedge Funds and Structured Products: Issues in Leverage and Risk; OECD

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