A Crisis of Credibility

Manic Monday, Tragic Tuesday, Black Friday...we are certainly not short of monikers to describe the current financial market meltdown that is threatening to drag the world into recession. But what everyone is suffering from is a short-to-medium term memory loss and failure to learn from past mistakes.

The nudge factor of the current market crash is the credit crisis that erupted in the summer of 2007 in the aftermath of the US sub-prime tsunami; the root cause of the current crisis is an obscure financial instrument called Credit Default Swaps (CDS) started in the US which created a new originate-and-distribute model of transferring risk. CDS is a contract that provides insurance against a bond issuer defaulting on its debt. CDS is supposed to provide peace of mind to the buyer to cover the risk of default and when these instruments began to get popular a decade ago, they typically applied to municipal bonds, corporate debt and mortgage securities. In a booming economy, there was little perception of danger of corporate default and CDSs began to be regarded by banks, hedge funds and traders as an easy source of money because while these agencies were tightly regulated, the credit swap market was not and was free to operate without restrictions. The CDS market then expanded into other, riskier instruments including the secondary market where speculative investors would buy and sell CDSs without any connection with the actual underlying instrument. In fact, the market got big because of speculators who, in a display of gallows humour, took bets on whether or not a company would go bankrupt. The CDS market exploded over the past decade to more than $45 trillion by mid-2007, about twice the size of the US stock market. Further, this and similar financial tools were kept out of reach of scrutiny by the Securities & Exchange

Commission & the Commodities Futures Trading Commission (both market regulators) through the Commodity Futures Modernisation Act of 2000. Thus, regulators could not verify that financial institutions like hedge funds or investment banks had the assets necessary to cover losses that they were guaranteeing. The CDS contracts could be traded or swapped without anyone overseeing or regulating trades to ensure that the buyer had resources to cover the losses if the security defaults; in fact, no one even knows how much the issuers are liable for. Worse, these were securitised and distributed to investors globally after obtaining mostly false prime and triple-A ratings from well-known rating agencies. This was not confined only to the US market but had spread all over the world with several global banks having large exposure to these so-called toxic assets.

This is uncannily similar to the unregulated energy trading markets that led to Enron's collapse that triggered a chain of corporate collapses followed by intensive regulation. In 2002, Enron ran a huge and almost completely unregulated derivatives exchange business that had little or no relation to any underlying fundamentals. The profitable derivates market attracted a frenzy of activity across small & large players, most of whom had scant understanding of the working of the market, such as it were, and were in it for the quick and easy money it delivered. One investor, however, saw through the hollowness of derivatives as early as 2002—Warren Buffet—and called it 'financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal'. The unregulated derivatives could create such a financial mess primarily because of a regulatory vacuum where no one was required by law or rules to post collateral to back up their positions or even disclose to investors the size of their huge derivatives position. After Enron and the spate of corporate failures, stringent regulations were put in place all over the world; Sarbanes Oxley and its global clones required companies to develop strong and robust internal control systems, have real independent boards and increased personal liability of directors and auditors but also raised compliance costs for the entire corporate world.

The crisis of 2008 reached a tipping point because of liquidity crunch faced by banks and the entire financial sector in the US following the sub-prime mortgage crisis. Investors in CDS markets took a hard look at whether parties insuring the instrument would, or more importantly, could pay up in the event of mass defaults. There was a steady write-down in the value of CDS holdings among banks, insurers and re-insurers. Rating agencies woke up to the impending threat and began to downgrade financial institutions. Downgrading rating of insurance companies was particularly devastating for market confidence because it called into immediate question the insurance coverage of banks and other corporates who have bought insurance covers from them, setting off a domino effect on the entire market. The magnitude and the seriousness of the crisis can be estimated by the fact that in the Mecca of capitalism & laissez faire attitude toward business, the US, the federal government took over management of two mortgage agencies, Freddie Mac & Fannie Mae to ensure their financial soundness.

But the takeover of these two companies did not stem the bleeding; one by one, the seemingly solid institutions either went bankrupt or were forced to sell cheap like Bear Stearns, Merril Lynch, etc. Lehman Brothers Holdings, one of the largest investment banks of the US has the dubious distinction of filing the largest ever bankruptcy protection at $600 billion in September 2008; it had large exposure in sub-prime and other lower-rated mortgage tranches when securitising the underlying mortgage and investor confidence in Lehman's financial soundness continued to get eroded because of lower results, company announcements of layoffs or simply rumours. AIG, a US insurance behemoth with presence in over 130 countries and several million investors all over the world had to be rescued by the US government but only because its failure would have been disastrous not only for investors but for the very credibility of US capital market in global perception.

The entire financial system of the world runs on a basic ingredient called trust. Trust has rapidly become a rare commodity and banks and other financial institutions are holding on to their money and not lending it out, unsure of who is the next to go bust and take their good money down. A meltdown in the CDS market has made insurance more expensive in US markets because lenders are being very cautious about credentials of their borrowers. The unexpected losses alone might not have caused a crisis had the losses been widely distributed but the losses were concentrated & hidden (in specific sectors like housing & real estate) in ways that created widespread fear and that threatens the entire system. The magnitude of failure of a couple of large players in the financial sector is huge as compared to a brick and mortar company. This is because the banking system is based on a formula of total funds which is a percentage of actual funds it owns. No bank can ever run profitably if it has to hold 100% cash reserve ratio and no bank can ever repay all depositors/lenders out of its own funds if there is a run on the bank. The required reserve ratio differs from country to country; US has a progressive rate ranging from 0% to 10% while UK, Australia & Canada operate on 0%, India mandates 7.5% and China 17.5%. The financial system is akin to a juggler's balls that must stay in the air all the time to carry on with the show. The prevailing mood in capital markets around the world is so gloomy that corporates and other borrowers are finding it difficult to even raise working capital, fuelling fears of a global slowdown or worse, recession. Adding to the bleak mood are cries of 'buy local' in some of the world's largest markets, notably the US, brought about by a fierce spirit of patriotism to help the local economy and not some foreign country. And we thought globalisation was here to stay!

Markets today are linked globally in such an intricate manner and major banks and investment agencies have a stake in so many global markets that a crisis that primarily originated in the US has engulfed the whole world. The sheer size of the US market and its liquidity crunch is sucking in money from all over the world as institutional investors rush to liquidate their foreign holdings to ease the pressure back in their home countries. The root cause of the current crisis can be summed up as: new and unregulated financial instruments which propagate an originate-and-distribute model of transferring risk, inadequate understanding of financial nuances by players, allowing speculative investors to operate without stakes and the role of regulators and rating agencies. In short, there has been a complete breakdown of corporate governance and management incentives in financial institutions.

It is inevitable that there will be a fresh round of regulations; unfortunately, regulation is often reactive and more inclined toward plugging loopholes exposed by innovative players who invariably seem to be a step ahead of regulators. Once again, despite Enron & Sarbox, off-balance sheet items and special financial vehicles are responsible for much of the mayhem. Also, poor risk management by financial institutions leaves investors wondering whether the magic formula of more independent directors touted as a remedy in the wake of Enron has had any effect; did the Board really have the capability to understand the intricacies of complex financial transactions? Already International Accounting Standards Board is looking at requiring lenders to disclose their off balance sheet interests in a strict form to improve the transparency of a bank's accounts. In April 2008, the Basel Committee on Banking Supervision has recommended measures that include establishing higher capital requirements for certain complex structural credit products such as collateralised debt obligations, strengthening capital treatment of liquidity facilities extended to support off balance sheet vehicles such as asset-backed commercial paper conduits, strengthening capital requirements of banks' trading books, enhancing disclosures relating to complex securitisation exposures strengthening risk management and supervisory practices including management of off balance sheet exposures, capital planning processes.

India has not been immune to the crisis and the government has responded by certain fiscal measures like reducing the cash reserve ratio to ease liquidity, delay government borrowings, etc. India faces a genuine prospect of slowdown of growth particularly in services and other export sectors besides facing a shortage of funds to finance its ambitious infrastructure projects.

The crisis of credibility that banks, financial institutions and particularly rating agencies face is something that will take time to recover and business will be subject to even higher levels of regulations. Enron had anyway raised the cost of compliance for global business but lessons of Enron have, sadly, not been learnt.

Kshama V Kaushik

Kshama V. Kaushik, Director Thought Arbitrage Research Institute (TARI) is a Chartered Accountant by profession and authors of two book 'Corporate Governance: Myth to Reality' and 'India Means Business - How the Elephant Earned its Stripes'.