Wall Street's Derivatives Casino

BY CHRISTOPHER WHALEN

Is today's eerily tranquil scene an illusion?

In the dog days of August, the House Committee on Financial Services tentatively announced hearings regarding the long-delayed implementation of the New Basel Capital Accord or Basel II. In a letter, some legislators asked that U.S. bank regulators hold off on issuing a new rule for public comment regarding Basel II until after the hearings, but the Federal Deposit Insurance Corporation board did the right thing, ignored the request, and approved the proposal for public comment.

In the hearings on Basel II on September 14, 2006, various representatives from regulatory agencies and the banking industry held forth on the pros and cons of the proposal. Though the regulators tried to present at least the appearance of a united front, the differences in their recommendations for implementing Basel II made clear that the New Capital Accord still has a long way to go before it will be adopted in the United States. FDIC Chairman Sheila Bair summarized the situation:

> "As the U.S. banking and thrift agencies proceed with the deliberative process for implementing Basel II, it is important that the new capital framework does not produce unintended consequences, such as significant reductions in overall capital levels or the creation of substantial new competitive inequities between certain categories of insured depository institutions. In this regard, there clearly remain several outstanding issues with the proposed rule."

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One of the "unintended consequences" Bair probably was not thinking about when she made that statement was the extent to which the easy money policy followed by the Federal Open Market Committee between 2000 and 2003 has created a vast speculative bubble in markets from real estate to credit derivatives. Fact is, regulators, legislators, and even bankers themselves feel an increasing sense of urgency regarding Basel II, if for no other reason than there are so many other pressing issues requiring attention—issues which the delay of Basel II implementation in the United States has effectively blocked.

Important as Basel II may be to the banking industry and to the U.S. national interest, the approaching trough in the U.S. economic cycle is stoking concerns about credit quality and collateral values. Among the issues which top of the list for the financial services industry is the generic question of how to get better counterparty risk data, especially for hedge funds and other organizations involved in Complex Structured Financial Transactions (CSFT) and Over-the-Counter (OTC) derivatives.

In September, a principal from one of the largest hedge funds involved in credit derivatives told an audience of professional risk managers that in 2007 and 2008 there will be a serious shakeout among hedge funds, broker dealers, and banks involved in creating credit derivatives and CSFTs. The reasons cited for this grim view: poor credit risk practices by the major derivatives dealers and even more deplorable deficiencies in valuation methods. The hedge fund COO described situations where dealers on both sides of derivatives trades report profits and a general inability by dealers to price CSFTs with any precision.

The festering situation inside Wall Street's derivatives casino is well known to bank regulators. For months now, Washington's focus has quietly been shifting away from the theoretical constructs of Basel II and toward the very real risk issues of counterparty credit risk and liquidity.

One hint regarding the degree of urgency came over the transom when a certain regulatory agency in Washington called in July to ask about applying structured data collection methods such as eXtensible Business Reporting Language or XBRL to gathering counterparty risk data *à la* the suggestions made by the Corrigan Group. In the July 2005 report by the Counterparty Risk Management Group, it was recommended:

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> "Financial Intermediaries should perform robust credit evaluations of trading counterparties prior to engaging in dealings likely to entail significant credit exposure. In doing so, they should obtain and evaluate various types of information from counterparties, particularly those whose creditworthiness depends heavily upon the performance of a leveraged portfolio of financial assets."
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> "The scope, quality and timeliness of information availability should be an important ongoing consideration in determining the amount and terms of credit to be provided."

XBRL is a machine-readable language for communicating business and financial data which has been adopted by the Federal Deposit Insurance Corporation for gathering bank call reports and is being assessed by the Securities and Exchange Commission for enhancing public company reporting. It is remarkable and encouraging that political appointees understand such bleeding edge technologies and are focused on gathering counterparty risk data at this level of detail and at this time. But the motivation and urgency for improving counterparty risk management is due, in part, to a growing

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sense that there are serious financial problems imbedding themselves inside the U.S. economy.

Perhaps Moody's illustrated the policy driver behind improving counterparty risk management techniques when it reported that sales of U.S. collateralized debt obligations or CDOs soared to a record $115.7 billion in the first half of this year, a 72 percent increase from the same period last year. Many CDO deals come with credit derivative enhancements and ratings from the major agencies of the overall risk of the deal. These ratings, in turn, are used to justify pricing. But does a sum-of-the-parts analysis support the price paid to the CSFT dealer? Generally, no.

Fact is, a growing number of senior people in government are pondering the use of new technology solutions to address issues like those raised by the Counterparty Risk Management Policy Group II (http://www.crmpolicygroup.org/report), in particular the issue of gathering sufficient financial statement data about hedge funds and other lightly regulated entities to understand counterparty risk.

By no coincidence, the major rating agencies announced a laudable new effort to draw up financial criteria for rating hedge funds. Just as the rating agencies have been the enablers of CSFTs, providing credit ratings of these unique asset structures which have been absolutely crucial to acceptance on the Buy Side, now they purport to be able to assess the credit risk worthiness of specific hedge funds, a reflection of just how important hedge funds have become to providing liquidity in the global markets.

Part of the reason for the rating agency initiative regarding hedge funds is self interest (that is, a fee), part the insatiable desire of investors for designer assets, but most risk pros still rely on collateral to "rate" their hedge fund counterparties. One liquidity maven at a top bank trading desk in New York tells an apocryphal tale of how a certain hedge fund went down because of a squabble between two principals, ending in messy litigation and uncertainty for the fund's counterparties. The funds financials, which were sterling, said nothing about the operation risk embedded inside these individual members of the hedge fund maggotry.

Suffice to say that the twin issues of counterparty risk and collateral valuation are rising to the top of the proverbial hops kettle in Washington. Modeling future capital needs for the purpose of Basel II has lost some priority compared to estimating the present-day capital needs of banks and other obligors that may be facing potentially fatal losses on assets currently carried on bank balance sheets at extremely optimistic valuations.

Chief among the new priorities is the new rule on Shared National Credits (SNC), including enhanced disclosure by hedge funds and other counterparties of CSFTs. The new SNC regime is going to move soon to the top of the regulatory agenda, probably with a new comment period to update the December 2004 request. Why is "Snick," as SNC is pronounced inside the Beltway, about to finally move after almost two years of torpor and long after the various regulatory agencies requested comment? Because the mounting threat of a serious systemic

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Rating the Hedge Funds

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event in the opaque marketplace for custom built assets—or, more specifically, the lack thereof—has begun to really worry some people in the world of risk analysis.

Consider by way of example the profile of a notional U.S. bank whose financial performance has been "enhanced" via the use of OTC derivatives and CSFTs. The subject is a good-sized regional bank, an institution that has grown more sophisticated in terms of the use of the trading book and more willing to purchase as well as go short OTC derivatives for both interest rate and credit risk management.

The bank was once a mediocre performer, but now has above average asset and equity returns. Over the past five years, our subject also progressively improved default experience. It's so good, in fact, that the bank is now in the bottom quartile of the peer group in terms of loan charge-offs. Volumes in purchased funds and derivatives have increased over the period, but the bank's earnings are more stable than its peers, picture perfect in fact. Almost too good to be true.

The worst nightmare of the regulatory community today is not the visible threat looming on the horizon, but rather the eerily tranquil scene in the marketplace for everything from loans to credit derivative swaps. Despite the growing list of anecdotal horror stories which are heard from the Buy Side about sharply discounted secondary market valuations for CSFTs—structures, mind you, which often carry investment-grade ratings from the major credit rating agencies—the data for loan defaults and related losses at banks remain well below historical norms.

As the FDIC just reported, in the second quarter, levels of non-current commercial and industrial loans were still near sixteen-year lows, albeit up now two quarters in a row. As already noted, a large part of the reason for the calm picture still visible in the credit markets is the Fed's generosity between 2000 and 2003. Easy monetary policy covers a lot of economic and political sins. John Dizard writes in the *Financial Times:* "If the founding Austrians had Marxists and Keynesians as their opposition theorists, the present-day Austrians have Alan Greenspan

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and Ben Bernanke and their enablers in the U.S. political system."

Ironically, the tools used by economists to guide monetary policy also dominate the world of risk management, but they don't really work. The chief obstacles preventing regulators and risk managers from understanding the nature of the next systemic tsunamis threatening the U.S. economy are 1) over-reliance on statistical modeling methods and 2) the use of derivatives to shift and multiply risk.

Of note, continued reliance on Value at Risk or "VaR" models and Monte Carlo simulations is enshrined in the latest Basel II proposal, the pending rule revision on CSFTs, and the SNC proposal. All share an explicit and common reliance on statistical methods for estimating the probability of a loan default, for example. These ratings, in turn, depend heavily upon stability in the assumptions about the likely size and frequency of systemic risk events. And because Fed monetary policy was so loose for so long, most of the assumptions in today's risk models badly understate the actual threat to the safety and soundness of the U.S. banking system.

Thus the urgency in some corners of Washington regarding counterparty risk management in general and revisions to SNC in particular. The new SNC proposal is likely to include a quarterly reporting schedule and enhanced disclosure of counterparty financial data by all bank counterparties, including hedge funds. Of note, one of the goals of the SNC enhancements is to gather private obligor default ratings by banks and to aggregate same to build a composite rating system for regulators to use to assess counterparty risk. That is, the creation of a privileged rating system for use by regulators to assess the efficacy of both bank internal ratings and third party rating agencies. Big brother is watching.

Bankers, after all, are not very good at understanding future risks, no matter how many ERM consultants they hire, default risk software implementations they direct, or meetings they attend at the Federal Reserve Bank of New York. Even making accurate observations about the present-day risk events seems to be a challenge. Witness the fact that commercial bankers as a group managed to direct more than \$2 out of every \$3 in political contributions this year to Republican members of Congress, even as the GOP looks ready to lose control over the House and perhaps even the Senate. If Barney Frank (D-MA) is the next Chairman of the House Committee on Financial Services, perhaps the industry will take notice of this operational risk event and adjust accordingly. ◆