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May 16th 2002

From The Economist print edition

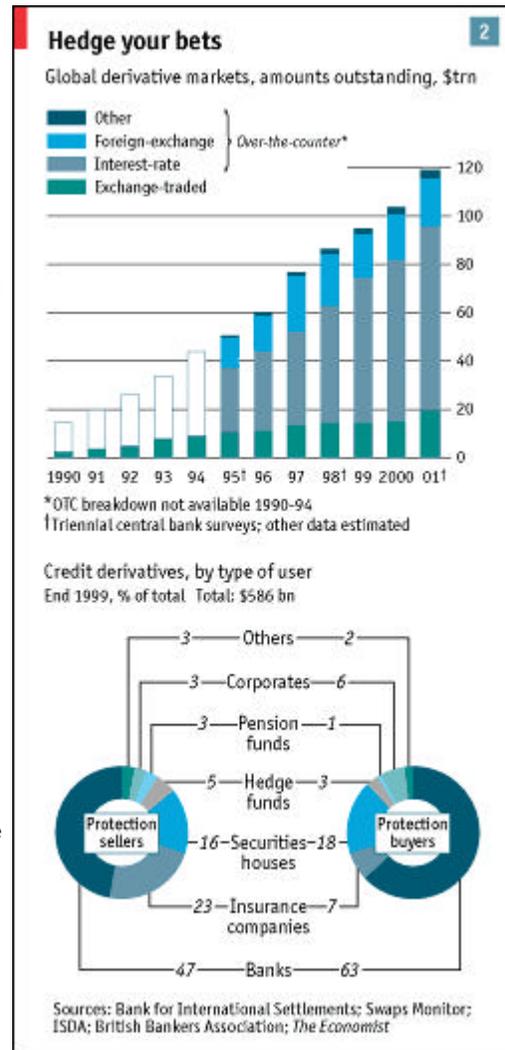
Relying less on banks and more on the markets creates fresh problems

BANKS are putting their eggs into more than one basket, and even selling some eggs to investors with baskets of their own. But are they as skilled at diversifying and transferring risk as they like to think? Are those to whom they are transferring the risk capable of managing it? Do these new holders even understand what risks they now bear? In short, could the shift from a bank-based system to a market-oriented one bring new dangers of its own?

Diversification does not absolve lenders from being prudent in their credit decisions. Banks have made some pretty dreadful loans in recent years. Obvious examples include the hundreds of billions of dollars lent to telecoms firms during the tech bubble, and generous credit extended to Enron and Argentina. From the mid-1990s, huge sums of money were promised to companies through guaranteed back-up credit lines to support issues of commercial paper, often without charge if no money changed hands at the time the credit lines were set up. When the economy turned down and credit became harder to find, many companies suddenly called on their back-up facility. By this time, lending billions of dollars to firms such as Xerox and Lucent had become an act of high-risk speculation that the banks had never contemplated, let alone priced, when the facility was first agreed.

One reason for this excessive generosity is that commercial banks were trying to win investment-banking mandates from companies, a business traditionally dominated by investment banks such as Morgan Stanley and Goldman Sachs. Underwriting an initial public offering or advising on mergers and acquisitions is much more profitable than lending money, so banks have been offering free loans to entice companies to give them investment-banking business. Judging by the chorus of complaints from the investment banks, this seemed to be working. However, the economics of the strategy are now looking less attractive in the light of the commercial-paper problems and a number of big losses on loans to large investment-banking clients.

The same forces that have pushed financial firms to grow bigger and more diversified are also raising the level of competition in the industry. In many product areas, a combination of fiercer competition, more transparency and the introduction of electronic systems is driving down margins. For example, margins on institutional brokerage are declining by around



5% a year. The collapse of IPO underwriting and the shrinkage of M&A in the past two years has taken out two of the few remaining lucrative areas of business, and helps to explain recent job cuts in investment banking.

Bob Gach, of Accenture, a consultancy, reckons that within a few years the industry could be dominated by only four to six global financial-services firms. Five years ago there were perhaps 20-25 banks with a chance of making it into this new "bulge bracket". Now the number is less than a dozen. Each of the winners will probably need access to at least \$100 billion of capital on its balance sheet. A few niche players will also survive. Dedicated investment banks such as Goldman Sachs will find it hard to decide whether to remain independent, says Mr Gach.

All this gives rise to various dangers. An ever-tighter squeeze on the profits of financial firms may tempt them to take bigger risks in their proprietary trading operations, in the hope of staying independent long enough to make it into the bulge bracket. A surprising number of them invested heavily in venture capital during the tech boom, and after initially trumpeting stellar returns have now had to write off most of the money.

Derivatives allow their users both to shed risks and to take bigger risks. This dual role makes it hard to tell whether their impact is benign or malign, and there are plenty of people who argue for each side. What is certain is that financial firms, especially on Wall Street and in the City of London, love derivatives, and have hired an army of mathematicians and physicists to work as "financial engineers", creating complex new derivatives to shift risk around the financial system. The market for these products is growing rapidly, both on futures and options exchanges and in private sales, which tend to be more complex and more lucrative. Credit derivatives already have a nominal value of almost \$1 trillion, up from around \$100 billion five years ago. They are forecast to top \$3 trillion by 2005. The nominal value of over-the-counter derivatives now exceeds \$100 trillion, 60% of which is handled by a mere five dealers, including J.P. Morgan and Citigroup. Derivatives and other tools of financial engineering can be used to manage risk better by hedging positions and transferring unwanted risk to a counterparty, which is what banks say they mostly use them for. However, those tools can also be used to increase risk, perhaps by a big margin, and there is a growing danger that this will be done accidentally.

Emanuel Derman of Goldman Sachs describes much of what a financial engineer does as "a high-tech version of estimating the unknown cost of fruit salad from the known price of fruit, or often, in reverse, estimating the unknown cost of fruit from the known price of fruit salad". A financial engineer can take the risk in, say, a bond and break it down into a series of smaller risks, such as that inflation will reduce its real value or that the borrower will default. These smaller risks can then be priced and sold, using derivatives, so that the bondholder keeps only those risks he wishes to bear. But this is not a simple task, particularly when it involves assets with risk exposures far into the future and which are traded so rarely that there is no good market benchmark for setting the price. Enron, for instance, sold a lot of those sorts of derivatives, booking profits on them straight away even though there was a huge question-mark over their long-term profitability.

Black holes

The consolidation in the banking sector may be increasing the riskiness of the financial system in other ways. In a recent paper, Avinash Persaud of State Street, a bank, describes the growing frequency of what he calls "liquidity black holes". Investors wishing to sell, particularly in large volumes, suddenly find that they can do so only at a much lower price than that set by brokers for small amounts, if at all. This is happening increasingly in some of the markets typically regarded as highly liquid, such as those for American Treasuries and foreign exchange, as well as in smaller markets such as for emerging-country debt. Volumes in the foreign-exchange market have fallen sharply (see chart 3).

The reason these black holes can develop, explains Mr Persaud, is that liquidity is a function not just of the size of a market but also of the diversity of opinion of those trading in it. The less they disagree, the less liquidity there will be. Several factors have reduced diversity, he argues. Technology has allowed information to spread faster, reducing the scope for disagreement arising from disparity of information. Consolidation has cut down the number of big market participants. In 1995, 20 banks in the United States accounted for 75% of forex transactions; by 2001, the number was down to 13.

Moreover, the big firms are increasingly using similar internal risk-management systems. These are sensitive to movements in the markets, and cause their users to respond in similar ways, so the few big firms that dominate the markets increasingly move as a herd, reducing diversity of opinion and thus liquidity, argues Mr Persaud. Some bank regulators say this danger is not all that significant because the underlying risks taken by financial institutions are quite different even if their risk-management systems are similar. But everybody agrees that less liquid markets may be more prone to financial crisis.



Is there a way of increasing the diversity of opinions? One possibility would be for institutional investors with different time horizons to become providers of liquidity. Big private investment-banking partnerships, such as Salomon and Goldman Sachs, used to be willing to take big contrarian bets in markets that they thought were out of line. But now that they are public companies, they are too concerned about short-term earnings volatility to take many such risks. Obvious candidates to take their place include hedge funds, which are free to invest against the grain of the market if they wish, and insurers and pension funds, which have very long-term liabilities and no need for market-sensitive risk-management systems.

Warren Buffett, a famously contrarian investor, often hints at this opportunity in the annual report of his firm, Berkshire Hathaway, which is, at root, an insurance company. The firm has plenty of liabilities that will not be called in for a long time, as well as diverse earnings, vast liquid resources and shareholders willing to accept the earnings volatility that can result from taking relatively risky positions. This "enables us to assume risks that far exceed the appetite even of our largest competitors", as Mr Buffett puts it.

Where the buck stops

Some insurance companies are now starting to take on some of the risk that the banking system and traditional market intermediaries no longer want. Swiss Re and Munich Re each account for about 10% of the credit-derivatives markets. Insurers have also become huge buyers of asset-backed securities.

This may have its downside. Diversity of opinion is certainly welcome, but few contrarians, particularly within the insurance industry, are as sophisticated and well-informed as Mr Buffett. Indeed, many insurers have a reputation as the hicks of the financial world. Tim Freestone of Seabury Insurance Capital, a consulting firm, reckons that the investment and risk management of the typical insurer is roughly as sophisticated as the typical bank's was 10-15 years ago. Few insurers have a good record of underwriting, supposedly their bread and butter. During the 1990s many insurance companies simply parked premiums in the stockmarket, where they grew so much that there was no need to worry about underwriting losses. Now that the investment climate is harsher, the insurers are looking for new high-yielding (ie, riskier) investments, which banks are providing through financial engineering.

Fixed-income products, such as asset-backed securities, are particularly attractive to insurers with fixed nominal liabilities who failed to predict low inflation and low interest rates. Much of the Japanese life-insurance industry has gone bust because of its inability to deliver promised nominal yields. In Britain, Equitable Life got into trouble for similar reasons.

But some observers worry that problems lie ahead when the true risks of these investments become clear. In its December 2001 Financial Stability Review, the Bank of England devoted a whole chapter to risk transfer between the banking and insurance industry, mentioning "challenges for market participants and the authorities: in tracking the distribution of risks in the economy, managing associated counterparty exposures, and ensuring that regulatory, accounting and tax differences do not distort behaviour in undesirable ways". Privately, one regulator admits that some insurers are "doing very racy investments to get yield".

There is a danger that this risk will eventually find its way back into the banking system. Much of the risk-transfer apparently being undertaken may be an accounting ruse, designed to escape regulatory capital requirements without truly shedding the risk. And if insurers are unable to meet their liabilities and go bust, the banks may be caught short. There are potential legal risks too. J.P. Morgan, for example, faces a court battle to get the \$1 billion it expected from a surety bond it had bought from a group of insurers to reduce its exposure to Enron.

Much of the risk may end up in the hands of less sophisticated investors, including some of the individuals now being targeted by the financial-services firms. They may be taking on this risk unwittingly. Nobody knows how those individuals might react if they found out, or how this would affect the economy as a whole. They might feel poorer and less inclined to spend, which could inflict the sort of damage on the economy and the banking system that the bears had predicted when the dotcom bubble burst.

If there is still a bubble in share prices, as many economists believe, the entire financial system—traditional and new bearers of risk alike—remains exposed to its bursting. But it has become harder than ever to say how great this exposure is.

Still, as long as risk remained concentrated within a country and largely its banks, its financial regulators should have been able to keep tabs on it. The trouble with today's global pool of capital is that regulators may be out of their depth.