

Derivatives on Subscription

Financial innovations have caused major turmoil in the financial sector. Critics support the introduction of tests, like in the pharmaceutical sector, before new products are introduced into the market. Central banks don't believe so.

By Egbert Kalse and Daan van Lent – NRC Handelsblad

In 2001 Daniël Aksan was trainee with JPMorgan. The students from his group were free to find a job within the bank. The derivatives unit, which in the years before invented the Credit Default Swap, was the absolute summit. "They were razor sharp", he says. Aksan, who after high school in the Netherlands, attended a 3 years banking course in the City of London, was of the up and coming young generation of bankers. They were not interested in becoming deal makers, they wanted to develop new complex structured products. The banks encouraged them because of the growing revenue stream they represented. A young guy like Aksan was given a lot of freedom. He was allowed to develop the most complex products, as long as he was prepared to put in the long hours. "Once I worked for three months 100 hours every week. Every morning, including Sundays, rise early and go fourteen hours in one stretch. It was working like I never had worked before."

Aksan thus followed in the footsteps of the first quants who entered into the financial sector in the eighties. Initially by invitation, like mathematician Fisher Black, who built his reputation in Artificial Intelligence, and who was invited by Robert Rubin, managing director at Goldman Sachs and subsequently Secretary of Treasury under Clinton. Fisher Black was asked to further develop the role of mathematicians and physicists at the bank. These quants opted massively for employment with banks. In the financial laboratories they could earn more than at the universities. These whizzkids viewed banks as a playground for their complex mathematical problems. With their knowledge they outperformed the traditional bankers who conducted their business based on their personal networks. The financial sector developed as a result of them into an industry in which huge computing power facilitated the introduction of highly complex products like credit derivatives and structured mortgage backed securities.

"People tend to fall in love with innovation", says Mohamed El-Erian, chief executive at American finance house Pimco. "Perhaps you know the feeling: you have just bought a brand new gadget, and wonder after half a year why you ever bought it." A lot of the financial innovations promised high returns at low risk. The chief executives of the banks believed that was true, their traders sold these products relentlessly and professional investors were willing buyers.

However, exceptions existed, as Hugo van Wijk explains about one of his customers. Van Wijk is Co-Founder and Managing Director at Vallstein, a firm that provides bank relationship management solutions to corporates. Whenever the relationship manager at a bank sought contact with this specific customer about the launch of a new product, the relationship manager always wanted to bring the product specialist along for a detailed presentation. The customer would have none of this. "If the relationship manager would be unable to explain why this innovation would be of specific use to the company, then how would the product specialist possibly know this?", says Van Wijk.

But most buyers had blind faith. Established credit rating agencies provided triple-A ratings to new products, the highest rating possible. Regulators and supervisors did not block any of these innovations. Nobody restricted growth, which was exponential. There was no elk-test, like one has with new cars before certified on safety. Supervisors believed self-regulation would filter out bad innovation because in that case nobody would buy. Regulators also were not equipped to hire equally smart quants to contain innovation.

Thus, since the late nineties a huge derivative market developed, worth trillions of dollars, without the supervisors having but a basic understanding of the complexity or the size of the products being traded. Nevertheless, supervisors believed they had the appropriate instruments to keep the banks under control: minimum capital requirements. For every part of risk weighted assets, solvency must be held. The higher the risk-weight of the asset, the higher the solvency requirement. However, these capital requirement rules proved to be inadequate.

“There have been periods in history that innovation moves so fast it is impossible to keep up”, says Nout Wellink, Chairman of the Dutch Central Bank, with hindsight. “In essence, that’s what happened in recent years. Liberalisation, deregulation, technical progress to make complex calculations with computers, all that was well ahead of the risk management practices within banks, ahead of what regulators introduced on new rules, and ahead of what supervisors were able to control”, he says. Central Banks and supervisors meanwhile openly admit that capital requirements were inadequate. Banks will be forced to hold more capital. Also the requirements of so-called stress tests conducted inside banks will become more stringent. “In due course additional capital buffers will have to be established that are available during downturns, but first we have to get this crisis behind us, otherwise we would act pro-cyclical”, says Wellink, who chairs the Basel Committee on Banking Supervision, which sets the minimum capital requirement rules. However, Central Banks are reluctant to regulate the pace of innovation. Wellink: “Which part of innovation must be restricted? You’ll need to build a system with checks and balances. Innovation carries risks, of course. But we just don’t know how big they are. Basel II provides a clear answer to that. If the product is new, when the risks are higher, you’ll need to hold more capital. A bank is also free to use that capital for other, less risky, things.”

Others make similar recommendation, like in the Netherlands the report prepared by the Maas-Commission (ex-ING), in the UK the Turner-Report and the De Larosiere-report. But there is also criticism. “It is such a pity that they all make the analysis but fail to draw the final conclusion”, says Van Wijk. In his observation, all reports rightfully identify the link between innovative products developed by banks to increase returns, under pressure in a quest for delivering shareholder value and the corresponding compensation received when such targets were met. But the reports shy away from saying that launching such new products onto the markets should be better regulated. “Rather contrary, they say that regulating innovation would restrict growth”, says Van Wijk, a former banker at i.a. Citibank and ABNAmro. According to him, this argument has serious flaws: “Also when you do regulate innovation you would contribute to economic growth.” Van Wijk already advocates since early 2008 a system of regulation for financial innovation like the medical and pharmaceutical sector have. Here, only new medication is allowed onto the markets when possible unwanted side-effects have been properly identified and assessed. Van Wijk doesn’t want a “Yes, Until” regulation on innovation but a “No, Unless”.

Economist Willem Buiter also subscribes to the analogy with the pharmaceutical industry. The Dutch professor at the London School of Economics and former executive of the Bank of England would like to see a list of approved financial instruments and institutions. Everything

not on that list should be banned, according to him. A new instrument, before being launched, should be submitted to serious tests by regulators, interested parties and academics, and be submitted to clinical trials first. And some use should be restricted to on subscription basis only, by professional parties and be kept away from the general public. "I do accept that this would slow the pace of innovation down, but so be it", says Buiters. "It slows down but does not stop it altogether. It makes innovation more expensive and less profitable. But the good thing is that risk on new, poisonous products that infect the system at large is being contained."

According to Professor Arnoud Boot of the University of Amsterdam, Central Banks should not be afraid to slow down innovation: "Would that be bad? Of course not. The financial sector has too much of a public function to take such issues lightly."