

Betting on the Titanic

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It has been almost three years since the crisis began. Households, businesses and governments, all overwhelmed, are struggling to get out of it, with a financial system – the cause of the crisis -- in need of extensive repair and redesign.

In order to redirect the financial system so that it is more stable, efficient and provides a better service to society, involves action on several fronts: improve the capital requirements of the various financial intermediaries, establish financial security systems provided by those generating risk, improve transparency and soundness of markets and products, improve oversight and governance of the financial system and increase financial education for households, businesses and governments.

Of all these groups of tasks, one is lagging behind the others on the work agenda: the one referring to products and financial markets. This is a matter for concern because the failure of the markets -- their products and agents-- and their transparency are crucial both at origin and in the solution of the crisis.

The trading of financial products in recent decades, dominated by deregulatory theories, has allowed, not only under legal rules - some more lenient than others- but rather often has left agents freely create new products and trade them without previous processes of authorisation and approval and with little information on their further use. This is something unthinkable in the food, pharmaceutical or automobile industries, for example. This should change as soon as possible.

In the forest ecosystem of the financial markets, we can find a good example: *credit default swaps* (CDS), a product that led AIG to bankruptcy in 2008 and played a part in the script of the "Greek tragedy."

What is a CDS and how does it work?

A CDS is an insurance contract against a default negotiated between two parties. The buyer acquires insurance on default - for all, or part of a stock, or a set of stocks - issued by a public or private entity. The seller of the CDS receives a premium – usually annually - for the period covered by the insurance.

For example, in late February, the cost of a CDS to insure default of the Greek bonds for 5 years was 400 basis points. The insurance buyer agreed to pay the seller 400,000 euros per year for 5 years (2 million euros total) to insure himself against default of a nominal of 10 million euros. CDS are not regulated in most countries, that is, if they are in any. This has created serious problems and can continue creating them if things are

not straightened out. I will highlight some problems of the CDS product as they are raised today.

First, the CDS is insurance – something its supporters reject, pompously calling it a swap or exchange of a stream of payments - but, and this is a big but, someone who does not even have the stock you want insure can buy it, something unacceptable in the insurance world. In jargon, CDS are called naked and are a speculative product that represents a major part of what is traded. Can you imagine that anyone taking out life insurance on your dear, little-liked neighbour or organising a market where anyone could buy and sell that policy? The incentives game could be perverse.

Second, the CDS seller sells protection against default or bankruptcy of an issuer – a company or a State - and should have the actuarial calculation and risk control tools needed, as well as sufficient financial resources to meet their obligations. This should be properly monitored. In the case of CDS regarding private issuers, we have a devastating example: it was the CDS on subprime mortgage bonds sold by AIG that led to their bankruptcy in 2008. The U.S. government, to prevent – they say - a global financial collapse in chain, had to handle payments amounting to 27,000 million dollars at 16 major banks (some European) who had bought CDS from AIG.

Third, the public debt CDS present even more problems. The default risk, for example, in the U.S., has probably increased as a result of the crisis. However, those who trade CDS on this hypothetical failure, suffer from a speculative dementia syndrome. If a default were to occur, the situation it would create would be chaotic. Is there any possibility that CDS holders can meet the threatened payments under these circumstances? I doubt it. It would be like buying insurance on the Titanic from someone travelling on the Titanic.

Fourth, the CDS are traded over-the-counter, i.e. bilaterally, and in 'non-organised' markets, which is an important source of risks. When Lehman went bankrupt, it was practically impossible to know who owed what to whom. The supervisors did not have an exact idea of the size, activity levels and risks of the derivatives in the over-the-counter market. Thanks to the Bank for International Settlements -which, a Spaniard, Jaime Caruana- runs, at least we have estimates of the volume of CDS that the banks have: the gross notional value of CDS at the end of the first half of 2009 was 36 billion dollars, (European).

Finally, given the present circumstances, the possibility that banks which are supported by public money, directly or indirectly, speculate against the governments that rescued them is simply absurd. Can Citibank or the Royal Bank of Scotland, insure, in the moral and economic sense of the term, against the bankruptcy or default of the United States or the United Kingdom and speculate on it?

Time to act.

Obviously, the CDS are not solely responsible for the problems in Greece, but they have played a role, not always clean, as we will discover and as we saw in the collapse of AIG. Naked CDS must be forbidden, period. It is lawful and necessary to enable investors to secure their investments with *ad hoc* products, but these must meet clear public standards. The CDS are not used as insurance products but rather to speculate on the evolution of the underlying asset. Futures and options in organised, more solid and transparent - although imperfect markets – that should be further developed, should be used for that. In the euro zone these products on Public Debt almost disappeared upon arrival of the euro, leaving only the futures and options on German bonds, and continue being almost non-existent for private issuers.

Financial innovation should not be prevented, but it must be controlled. The CDS, like other derivatives or structured products traded over-the-counter, are leveraged products that can interact with others producing upward or downward overreactions on the price of real values and generating risks to the system. To mitigate their negative effects and ensure positive ones, they should all pass a *stress test* managed by supervisors. Those that pass should be traded on organised, supervised markets, and settled through a central counterparty camera. What to negotiate, how to negotiate, by whom, how much and at what price? At least the supervisors should know the answers to all this.

Due to the crisis, the CDS are finally being talked about. We hope that governments, regulators and supervisors and the financial sector will finish their long exchange of ideas and make some decisions. Much will depend on private initiative - if it is able to offer solutions - , but let us not forget that the ultimate responsibility is on the public side. The first bankruptcy of a hedge fund because of the subprime mortgages and the related CDS took place in February 2007. A long time has passed and there are initiatives to tackle the problems I mentioned. It is time to act decisively on the products and financial markets that failed. We must alleviate the symptoms of the crisis that affects us, but we must stamp out the disease that produced them. Just by trying, will we increase the confidence that is so badly needed.