An analytical eye

Jon Moulton has won something of a reputation as a Cassandra for his views on the likely depth and longevity of the credit crunch. The chief of private equity firm Alchemy Partners has warned on several occasions that the sheer number of highly leveraged companies makes a spate of corporate failures inevitable. He also fears that politicians will be tempted to impose a new raft of regulations as a result.

Moulton outlined his thoughts to ACT members when he gave the ACT's Spring Paper in late May at the offices of the Royal Society of Medicine. As he told the audience, his presentation largely mirrored one he had given only days earlier to parliament's treasury select committee.

He located the genesis of the crunch in the years of favourable economic conditions up to mid-2007. The long boom created a "new wall of structured debt instruments" that provided cheap debt in great volume. "People got very rich funding assets to take advantage of this financing," he said. "But when the good assets ran out, integrity went to hell as people paid higher prices to acquire inferior assets."

DETERIORATING STANDARDS Lending standards deteriorated to the point where, in the opening months of 2007, around 56% of sub-prime loans in the US states of California and Florida were granted on nothing more than verbal verification. The majority of the UK's major mortgage lenders were more cautious and the verbal verification-only figure here was little more than 20%.

The eventual result was that boom turned to bust as the poorer assets – particularly those in sub-prime – couldn't generate enough income to pay the interest due.

As these acts unfolded, the supporting players on the sidelines were ratings agencies whose ratings for structured finance products proved unreliable, banks that made small gains but much heavier losses, bankers who made a little but whose subsequent losses were also smaller, and the "unequipped and disorganised" regulators. The latter, in the UK, is the unsatisfactory 'three-wheeled vehicle' consisting of HM Treasury, the Financial Services Authority (FSA) and the Bank of England.

ISSUES ARISING FROM CREDIT CRUNCH Moulton highlighted the following issues arising from the credit crunch:

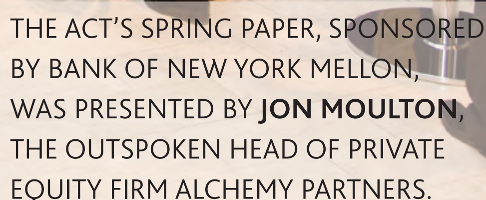
- **Bonuses and payments for failure** Both stand at historic peaks and help explain why banks' long-term strategies appear to have been abandoned in favour of an obsessive focus on the current deal. After a spate of massive writedowns, these payments could, and should, be a critical risk factor for regulators. Indeed the FSA's Chief Executive Hector Sants recently said the body plans to incorporate incentive structures into its risk assessment process.

- **Bank capital** The international capital framework of Basel II is "clearly imperfect", said Moulton – Northern Rock apparently met its requirements – and overcomplexity makes many of its calculations unclear. At the same time, banks that should be conserving their capital are instead maintaining and even increasing their dividends. Moulton suggested that it might improve public confidence if a minimum floor were established for bank capital, which would be a straightforward requirement, easily understood by everyone.

- **Base rate** Once central to the running of the economy, this has become "a notional number" that no longer serves much useful purpose, as demonstrated by recent base rate cuts that have seen Libor move in the opposite direction.

Executive summary

- Deteriorating standards in lending up to mid-2007, particularly in the US, inevitably led to issues arising from the credit crunch, including bonuses and payments for failure, bank capital and base rate. This has had repercussions for the financial world which has been affected by rising complexity in increasingly interconnected markets. Unfortunately, greater transparency is not necessarily the answer: disclosure only works if you understand it.



THE ACT'S SPRING PAPER, SPONSORED BY BANK OF NEW YORK MELLON, WAS PRESENTED BY **JON MOULTON**, THE OUTSPOKEN HEAD OF PRIVATE EQUITY FIRM ALCHEMY PARTNERS.

FINANCIAL WORLD REPERCUSSIONS These developments have repercussions for the financial world. Everything has become more interconnected and the credit crunch may yet produce many more effects.

Moulton cited the role of some of the monoline insurers that had guaranteed the debt of the many collateralised loan obligations and collateralised debt obligations that were issued. He observed that these monolines had offered the easiest way for sub-prime instruments to secure an AAA rating. Yet the monolines' own AAA ratings rested almost entirely on the say-so of the ratings agencies, which appeared to ignore the fact that they could be guaranteeing up to 100 times their net worth in loan guarantees.

This anomaly was eventually noticed by the markets. To reassure them, the monolines purchased reinsurance in the form of credit default swaps (CDS) from the major AAA-rated insurers such as American International Group (AIG). This reassurance endured until some of the brokers in California and Florida began suffering huge default rates on sub-prime mortgages.

Things started to unravel from this point. The defaults imperiled the net worth of the major insurers, which were downgraded from AAA to AA, with the monolines swiftly following suit. As the CDS became more of a risk and liabilities increased, so ratings suffered.

"Losses begin to result in every other form of business they [the major insurers] do," said Moulton. "Their ultimate losses are a massive multiple of sub-prime loss; effectively a CDS death spiral. This is very frightening territory."

AIG's first-quarter results, released in early May, showed the group's net worth at $80bn against a CDS portfolio of $475bn, he said. AIG has so far written off $21bn, of which $9bn was in the last quarter. Yet the first quarter also saw the group raise its dividend and increase the remuneration of those in its structured finance group.

ADVICE TO CORPORATE TREASURERS IS NOT TO PUT THEIR TRUST IN RATINGS AND ALSO NOT TO BELIEVE IN TERMS SUCH AS "SUPER SENIOR" AND "ENHANCED" THAT ARE ROUTINELY ATTACHED TO FINANCIAL INSTRUMENTS.

"The fear in the markets is that because all of this is so complicated – and the language used by AIG so impenetrable – there is good reason to believe that there are worse problems to come."

WHY GREATER TRANSPARENCY WON'T WORK Moulton posed the question of whether regulators can keep abreast of the more complicated and interconnected markets. They are evidently here to stay, creating an environment where ultimate losses can be a big multiple of the so-called actual loss. Complexity is steadily increasing, yet the skills of both directors and regulators have limitations.

This means that greater transparency won't address the problem, Moulton suggests. Disclosure "only works if you understand it". A current set of bank accounts now runs to immense lengths and has become impenetrable to all but a few; last year, HSBC's ran to more than 400 pages.

But there are a number of other measures that can be taken to ensure that banks stay strong and maintain financial stability:

- limiting their activities to only those that can be regulated;
- increasing their capital reserves as the economy recovers – a process that should begin immediately by imposing a freeze on dividend payments;
- requiring a clearer capital setup;
- sorting out the "regulatory hydra" and improving regulation (Moulton suggests the system of 20 years ago, while imperfect, was superior to the current one);
- improving the bail-out system;
- introducing similar requirements for insurers; and
- allowing most non-banks, including hedge funds, to fail rather than attempting to bail them out.

His advice to corporate treasurers is not to put their trust in ratings and retain scepticism about terms such as 'super senior' and 'enhanced' that are routinely attached to financial instruments. Moulton added that treasurers can also regard base rate as worthless – Libor "is poor, but the best we have" – and should keep a close eye on UK tax developments.

His own view on prospects for Britain's economy is equally downbeat. "The fundamentals are weak and, in such an environment, who wants to go long on sterling?" he said. "It seems likely that, in the near future, we will have another period of Thatcherism and have to cut back."

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