

Concepts...

"Concepts" is published by Daedalus Oversight to raise as many questions as it answers. It is driven by the belief that the industry, its products and its services are ever evolving. The ideas reflect the challenges faced in the continuous journey of innovation and improvement.

Crisis in Finance:

"I was particularly struck by the extraordinary difficulty of proving a case against any one person..." Hercule Poirot, *Murder on the Orient Express*. As Poirot wrestled with this conundrum in the famous Agatha Christie murder mystery, many commentators have struggled to find a convincing suspect for the credit crisis. The following characters have all been individually accused of responsibility for the current mess: The Community Re-investment Act and Government sponsored low income lending by banks, Fannie-Mae & Freddie Mac's 'implied' government guarantee of mortgage-backed-securities (MBS), consumers buying or speculating on houses they couldn't afford, companies over leveraging, the Government spending too much money, the Federal Reserve creating artificially low interest rates, the removal of the moral hazard reducing the risk premium on lower rated assets, banks creating Special Investment Vehicles (SIV's) which issue Commercial Paper (CP) backed by mortgage securities, Collateralized Mortgage Obligations (CMO's) and their apparently safe & distinct tranches, asset rating agencies poor assessments of these derivative products, Credit Default Swaps (CDS) pricing insurance risk and Insurance companies believing the price of that risk. As Poirot was famous for suspecting everyone, consider one more, less suspected



I was a CFO, but liked the outdoor life and found I had transferable skills!

character: Bank Capital requirements. In the pursuit of a simplistic solution to bank integrity, the industry has focused on bank capital with the reserves adjusted to the quality of assets on the banks' balance sheets. With minimal to zero capital requirements on AAA-rated securities in these recommendations, there was a natural increase in demand for AAA-rated securities for banks. With an over-supply of mortgage securities and finite bank balance sheets, it was only a matter of time before someone married one type of demand with the other supply via AAA-rated structured products.

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The ease, with which AAA-rated securities could be created, lead to more supply being met by the demand of SIV's effectively re-characterizing long term assets (MBS) into short term financing (CP). When disaster struck, the effective duration mismatch problem combined with a rightful lack of confidence in increasingly failing securities became misclassified as a "liquidity" problem for banks balance sheets.

The "liquidity" of a bank's assets became the new focus of bank oversight guidelines. At this point the bank guidelines have worked their way from capital requirements (Equity) to liquidity (Assets). The former is an arbitrarily enforced collateral haircut and the latter is an even more subjective description of balance sheet health. At this point wouldn't it be prudent to consider the only remaining section of the balance sheet left as well? Or will it take a securities "liquidity" crisis in the future for the Liabilities (i.e. funding) to reach the attention of the regulators? If Liabilities are included in the analysis, there could be a return to an assessment tool that seems to have fallen out of fashion: Asset & Liability Management (ALM). Rather than focusing on the make-up of a bank's capital or the assets that it has on its books, wouldn't it be better to match the timing of the Liabilities to the Assets while treating Equity (i.e. Capital) as special class of long term liability?

Despite this critical summary of Bank Capital guidelines, it is not enough for even Poirot to solely accuse them in this case. In the fictional mystery, all the suspects were guilty of the murder. However, all the guilty parties are not arrested on the moral basis that the victim was a wrongly-acquitted, multiple-child-murderer and that there was a plausible alternate, fabricated explanation requiring a missing, unidentified and unaffected instigator. Similar to the mystery, in the credit crisis, the un-accused, guilty instigators have all moved on, blameless. Unlike the mystery, these guilty instigators are now blaming everyone but themselves and the real, blameless victim is the credibility and faith in capitalism.

ALM, beyond the Pension and Insurance industries, has historically focused on derivatives meeting capital requirements rather than holistic balance sheet health. There needs to be a return to basic ALM; the increased use of the "quick (acid test) ratio" amongst other tools. A perspective on how these techniques can be applied to companies, banks, individuals and governments to help diminish, if not avoid altogether, a future financial crisis is the subject of the next newsletter.

Paul F Dowding

Daedalus Oversight would be pleased to discuss the realization of these concepts with you further. We thank you for your consideration.

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