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The rights and wrongs of structured product valuation: A round-table discussion with Alistair Milne (Cass Business School), Kenneth Sullivan (ABN AMRO) and Ian Wright (FRC) held on Monday, June 30, 2008 at Innholders' Hall, 30 College Street, London EC4R 2RH, from 12:30-2:15pm.

The credit crunch has left investment banks sitting on billions of pounds worth of structured products that they produced during the good times. What can explain this – greed, bad models, perverse incentives? And how does the market extract itself? The first speaker was most concerned with how banks got into this mess. In particular he was interested in what business models the banks were using, and on technicalities such as modeling, fair value accounting and incentives.

On the first issue it was possible the business model encouraged warehousing of these securities. One member said the UBS report to shareholders highlighted positive carry – that the yield on the products outstripped the cost of funding them, thus creating an incentive to produce more. Another said some banks exploited regulatory arbitrage, effectively moving whole operations off-balance sheet to benefit from higher gearing. The first speaker said that since many of these products were AAA-rated, banks might have viewed them as economically equivalent to government bonds. The higher yields encouraged them to keep them on their books although in retrospect the yield was not high enough to offset the liquidity risk. Nor had the banks accounted for a risk of a severe US recession, given that fundamentals often drive liquidity. Now that the market downturn is underway investment banks are no longer able to do what they are best at – matching buyers and sellers. One possibility going forward is that banks return to traditional bookbuilding exercises to encourage the sale of these warehouses products.

The second speaker it should not be forgotten that securitisation had brought benefits by distributing risk and allowed low-priced credit by large swaths of the population. It was the complexity and lack of transparency that led to the mispricing that came back to bite the banks in the form of liquidity risk. This came in the form of a loosening of credit standards, extreme levels of leverage, lack of transparency and the use of off-balance sheet vehicles. Accountancy standards were not the root cause of the crisis. In fact, he said, fair value accounting could end up the hero of the day rather than the villain of the piece, as it would add pressure on firms to face up the losses.

The third speaker said the real question was what could be done to get the market working. Loss of confidence and trust was the real issue and not things that could be captured by accountants. In fact banks may very well be happy to hold these assets and write them down rather than sell them at a huge discount. One member said it was significant that the afflicted banks were able to raise capital from groups such as sovereign wealth funds, and so did not need to sell. In fact, there was a queue of people wanting to invest in western banks. The third speaker flagged up technology as a way to get the market moving, perhaps by adapting the XBRL technology that enabled analysts to “tag” accounts.

Fundamentally there is what one member called the “school fees problem” – that investment bankers are greedy and selfish, as they simply want to earn large bonuses. One member said the attitude of courts would be crucial as claims started to come in. He said there were signs that judges were no longer seeing investment decisions as laissez-faire speculation but as an area where they should exercise more scrutiny. While the prospectus for a structured deal might technically contain a risk caveat, courts may simply say ‘this went wrong’. Courts should be interested in banks that were shorting subprime while at the same time selling structured subprime products, one member said. The chair said that looking forward, it was important to emphasize the benefits of securitisation and seek a way forward. Apart from anything, thanks to pension funds and sovereign wealth funds, the thirst for yield is still out there.