The Risk Paradox and Limits on Financial Innovations

Prof Dr Hans J. Blommestein
Tilburg University, The Netherlands
and OECD, France
Journée d’étude sur la crise bancaire et financière

Le 8 décembre 2008, Université Paris 8, À l’initiative du CEPN (Université Paris-Nord) & LED (Université Paris 8)
The Author and Disclaimer

- Dr Hans J. Blommestein is the PricewaterhouseCoopers Professor of Finance at Tilburg University, the Netherlands, and Head of the Capital Market and Public Debt Management Unit, OECD, Paris, France

- The views expressed are personal and do not represent those of the institutions with which the author is affiliated
Outline of presentation

• I. The risk paradox
• II. The importance of sound banks’ risk management systems and derivatives for mitigating the risk paradox
• III. The future of financial innovations
• IV. Complex derivatives and the need for higher market- and regulatory standards
The Risk Paradox

• An increase in standards of living
• More complexity
• Higher systemic risk
• More financial fragility
• Too-complex-to-fail (TCTF)
Failure of risk management systems

• Banks failed to control risks related to securitisation models: market-, credit-, and liquidity risk

• More attention to liquidity risk →
  – (a) incorporating liquidity facilities into banks’ internal liquidity management
  – (b) consolidation of off-balance sheet (special purpose) vehicles
  – (c) greater role for stress tests and contingency plans
Future of securitisation

• Invalidation of existing business models?
• Securitisation as a business (including O&D models) is unlikely to disappear
• The benefits of securitisation and pooling assets and tranching liabilities are many-fold and have not gone away
• But the structured credit market needs to changed fundamentally
Fundamental changes in structured credit markets

• Preserving securitisation benefits while eliminating weaknesses at origination side (retaining ownership of loans)

• ‘Tighter’ (simpler) structures → one-layer securitisations such as CLOs or corporate CDOs

• Multi-layer securitisations → unresolved issues (complexity, valuation challenges, liquidity- and operational risks, external ratings), leading to shrinking or disappearing of markets (e.g. ABS CDOs; CDO²)
The future of financial innovations

• Ongoing credit-cum-liquidity crisis is putting many complex derivatives in negative light
• Failure to understand some of the risks (market-, liquidity-, pipeline-, and tail risks)
• Insufficient due diligence on many new Credit Risk Transfer (CRT) products
• Fall in the (short-term) demand for (some categories of) derivatives.
• Longer-term perspective → scope for the further transfer of risks (innovations) in society is enormous
Six key market- and regulatory standards

• Necessary to reap the full benefits of an open and complex financial landscape

• Seriousness of risk paradox will be mitigated

• Complex derivatives will continue to play a central role in the more efficient allocation of risk and capital

• Moral hazard associated with TCTF situations will be kept at an acceptable level
(1) High(er) standards of risk awareness and risk management

• Financial institutions need to have in place systems for more effective risk monitoring and control. Systems need to be able to account for:
  – (i) more ‘tail’ correlation between asset classes
  – (ii) additional scenarios in which correlations break down (economic scenario generators and stress tests)

• Consolidated risk management is essential
(2) More effective procedures for risk-managing derivative positions

• Strong clearing, trade matching and confirmation infrastructure
• Adequate legal and regulatory framework
• Transparency, product suitability, prevention of market abuse, and best execution
• Manage operational-, market-, credit and liquidity risk using stress-testing
• Better understanding of the risks related to derivatives and MVSs
(3) Infrastructure of the OTC derivatives market

- Counter-party risk
- Cash settlement vs physical delivery
- Delays confirmation of trades
- Problems with settlements rules
- Trade-off between efficiency and stability in the OTC market?
(4) Capacity of supervisory and regulatory agencies

• Mitigating moral hazard associated with Too Complex To Fail (=TCTF) situations

• Doubts about pillars of the new financial landscape:
  – Problems with rating agencies
  – Questions about soundness banks’ internal ratings
  – Regulation liquidity risk, capital requirements structured credit products and trading book
(5) International accounting standards

• Accounting guidelines consistent with risk management procedures and supervisory objectives

• Valuation problems structured credit markets

• Better accounting rules for asset valuation of debt instruments & off-balance-sheet vehicles

• Valuation options structured investments with market liquidity problems
(6) Adaptation business models

- Incentive structures have led to riskier markets
- Compensation functions are convex in returns
- Financial innovations can be destabilising (W. Buffett: derivatives as WMD)?
- Perverse incentives in originate-and-distribute models