Viewpoints on Financial Culture (3)

Transformation, Transfer, and Transaction of Risks

The matching of the different risk appetites of investors with the different risk profiles of fund raisers can be achieved through the transformation, transfer, and transaction of risks. Banking, in its fundamental form, involves largely the **transformation** of risks. By lending money to those in need, the banks take on the credit risks of borrowers; and by taking deposits from those who have money as their principal source of funding, the credit risks of the banks are being assumed by depositors. Thus, the risks of different borrowers not being able to repay money to whoever are providing them the money they need are transformed in the process into the risks of the banks, which are supposed to be well run and adequately supervised by the relevant authorities, not being able to repay money to depositors. In other words, the risk profiles of those in need of money, which are generally unfamiliar to those with surplus money, are transformed through banking into a more familiar form that is a better match for the risk appetite of those who have surplus money.

The transformation of risks involves the financial intermediaries (the banks) taking on risks themselves. It is obviously not unreasonable to expect them to be able to do so, on a sustainable basis, through macroeconomic cycles and short-term (and even unexpectedly sharp) volatility in financial and other asset markets, which affect the ability of borrowers to repay money and at the same time increase the likelihood of depositors to withdraw it. This task is so important to the economy that whoever is doing it—the banks—needs to be prudently run, for example, with adequate capital to absorb large and unexpected losses, and ample liquidity to meet deposit withdrawals in stressful conditions. Regrettably, the history of banking is a disheartening one, to put it mildly, leading all concerned, particularly those with the responsibility to protect the public interest, readily to draw the conclusion that the banks cannot be left on their own to perform this task. And so banks are, in all jurisdictions, subject to a framework of licensing and prudential supervision by the authorities. Even then, for a variety of reasons, we still have banking crises all too often erupting, causing serious disruptions to the financial intermediation (through risk transformation) that is essential to the functioning of the economy.

The reasons for this unhappy state of affairs in banking are complex, but two interactive underlying forces are at work. On the one hand, there are too many distractions from activities that are non-essential or irrelevant to financial intermediation through risk transformation for the banks. The profit motive mobilizes them to devote resources and attention to these, arguably more rewarding, business opportunities, which are not specifically prohibited by law, to the extent that the performance of their essential task is compromised. On the other hand, the supervisory framework—realistically the product of different, perhaps opposing, political influences between the supervisory authorities and those being supervised—is simply inadequate for the task at hand. Remediation efforts should thus focus on limiting distractions for the banks and enhancing prudential supervision, all in the spirit of ensuring that the banks perform more effectively what they are supposed to do—very much a cultural change. They do not necessarily involve more costly and complex compliance arrangements in the banks and more intrusive and prescriptive supervision by the authorities.

There are other, more sophisticated means of risk transformation. Credit guarantee, credit enhancement, and credit default swaps are examples. These, in essence, transform credit risks that are unacceptable or unfamiliar (though simple) to investors into a totality of risks (credit risks of guarantors, counterparty risks arising from swap arrangements, etc.) that apparently better suit the risk appetite of investors, whether acting on their own or through participation in such institutionalized fund management arrangements as provident funds and hedge funds. Whether or not these complex risk transformation arrangements serve the purpose of better matching the different risk appetites of investors with the different risk profiles of fund raisers is, however, debatable. On the face of it, or at least the financial intermediaries involved in organizing these arrangements would have all concerned believe, investors of a given risk appetite would get a higher rate of return for their money, and fund raisers of a given risk profile would have access to cheaper money. The jury, I think, is still out. I am skeptical. The yield enhancement and the lower cost of funds promised respectively for investors and fund raisers appear inconsistent with the very attractive fees charged by the intermediaries responsible for bringing those risks transformation products to the market. The matter is probably too complex for any simple and definitive views to be taken on it, particularly when financial markets are too dynamic for analytical work involving ceteris paribus assumptions. Meanwhile, we did have, in the financial crisis of 2007–08, the near collapse of at least one large US financial institution active in this type of risk transformation business to contend with. But all concerned should at least be prepared to question the utility of these arrangements, from the point of view of better serving the economy, and perhaps be a little more conservative from that perspective in embracing those that look dubious.

The financial system also matches the different risk appetites of investors with the different risk profiles of fund raisers through arrangements that in effect **transfer** risks. A simple form of risk transfer is for financial institutions to organize debt issues for fund raisers and separately to market such debt to investors at the wholesale or retail levels as appropriate. Thus, the credit risk of fund raisers not being able to repay money borrowed through redeeming the debt issued when due, initially assumed by the financial institutions arranging the issue, perhaps through underwriting the issue or simply taking on those debt initially onto their balance sheets, is transferred to investors. Institutional investors, who are capable of assessing risk, are happy to make use of this service and take on those risks, given the lack of direct access to the fund raisers. Retail investors, with the benefit of advice from financial institutions familiar with the relevant risks and marketing the debt, are also happy to assume those risks and enjoy an investment return commensurate with them. For example, in the case of debt issued by governments—treasury bills and bonds—the appointed primary dealers, through marketing the debt allocated to them, in effect transfer sovereign risks to investors who otherwise would not have access to the debt.

Risks can also be transferred through what is generally referred to as securitization. This started as an arrangement for introducing liquidity to basically illiquid risk assets, which are pooled together as a portfolio of assets and securitized through the issue of debt secured upon that portfolio as a whole. The securitized debt is then marketed to investors, supported by market-making arrangements to provide liquidity for it. Illiquid assets of lenders are thus transformed into liquid assets and transferred to investors. A familiar risk transfer arrangement is the securitization of home mortgages, where standardized home mortgages are packaged and sold to investors as mortgage-backed securities (MBS), enabling investors to take on the traditionally low risks of home mortgagors defaulting and enjoy a rate of investment return reflecting but not necessarily identical to home mortgage interest rates. There are, additionally, the attractions of mortgage-backed securities being liquid, so that investors can realize their investments should they for whatever reasons wish to do so, and the prices of those securities fluctuating (and therefore creating chances for short-term profit) in accordance with the outlook of interest rates. While these additional factors may well have become the main attractions to investors, it should be recognized and remembered that the underlying risk transfer function of securitization is a matter of public interest and therefore of overriding importance and should not in any way be compromised.

Apart from home mortgages, there are other risks that can similarly be transferred through securitization to satisfy the different risk appetites of investors. The generic term used in the financial system for this type of activity is the issue and sale of asset-backed securities (ABS). Bank loans, as an asset class, can be securitized with the loans serving as collateral—the so-called collateralized loan obligations (CLO), so can different types of debt—collateralized debt obligations (CDO). Perhaps for want of a different name or somewhat different structures to attract investors, there are also asset-backed commercial paper (ABCP) issues. For a variety of reasons, regrettably not motivated by the desire to serve the public interest, these credit risk transfer arrangements proliferated during the decade or so ahead of the financial crisis of 2007–08. They also became very complex, involving the pooling of a wide spectrum of risk assets and slicing the portfolio into different tranches that were, however, given clear credit risk ratings by established rating agencies. There were so many acronyms used that the financial system looked, at least to me, like a bowl of alphabet soup that is so thick you could not see the bottom of it. Systemic and unfamiliar risks got created and concealed. Worse still, the ability to "originate and distribute" such complex financial products at ease seriously eroded credit standards. Assets of doubtful quality, such as the notorious sub-prime mortgages, were created and offloaded as good assets in the performance of the important function of risk transfer by the financial system. All this ended in misery for many on a global dimension.

Turning to the **transaction** of risks; clearly, if risks in the form of financial assets can be readily bought or sold at a fair price, in other words, if there are reliable liquidity and efficient price discovery for these assets, the appetite for risk-taking and the ease of raising money would be enhanced. The riskiness of financial assets can, of course, change along with the constantly changing economic and financial environment. For example, the prices of fixed income securities such as government bonds rise when interest rates are trending down. The ability on the part of investors conveniently to add, or reduce, risks on the basis of their judgment of the relevant prospects would increase their willingness to take on risks. At the same time, a mechanism whereby fund raisers can readily raise money through selling their own financial obligations, whether in the form of debt promising the repayment of money with interest or equity offering investors a share of the business they are undertaking, would obviously help their business ventures. Thus, in terms of effectively matching the different risk appetites of investors with the different risk profiles of fund raisers, a trading platform or a market for the transaction of risks, providing reliable liquidity and efficient price discovery for risk assets, would be beneficial. These are the fundamental purposes of financial markets, and they are of overriding importance, not the provision of a platform for making quick money through engaging in all sorts of trading strategies.

Here, it is essential to distinguish between the primary market and the secondary market, specifically the respective roles that they play. Of primary importance is indeed the primary market, where new money is mobilized from those who have it to those in need of it, and productive economic activities are made possible. The primary market is also where new financial instruments are created. The secondary market is indeed only of secondary importance in that it is there to provide liquidity and price discovery in order to enhance the attractiveness of those financial instruments to investors. The prices of the financial instruments transacted in that market reflect investors' perception of what they are worth, having regard to the changing conditions that affect the prospects of the businesses underlying those financial instruments. This price discovery function in the secondary market also serves the important purpose of providing hopefully reliable references on the prices at which money is to be mobilized in the primary market.

Regrettably, however, in the real world the means and ends in respect of the two markets get confused. The transaction of risks in the secondary market (for example, the buying and selling of shares in the stock market) has become a money-making activity that affects the immediate interests of a great number of people—individual and institutional investors, stock brokers, market-makers, and financial advisors and journalists. By contrast, financial intermediation made possible in initial public offerings (IPO) in the primary market, although essential to supporting the economy and hence an important matter of long-term public interest, only affects the immediate interests of the issuers and the relatively small number of investors subscribing for the new shares. Often the short-term interests of the rather vocal and influential stakeholders of the secondary market overwhelm the long-term public interest represented by a well-functioning primary market.

A disappointing (at least to me) manifestation of this confusion is how the market measures the success of an IPO. This is by reference to the degree of oversubscription and the increase in price when the shares are first traded in the secondary market compared with the issue price. But huge oversubscription and large immediate price gains are actually reflections of failure in accurate price discovery that clears supply and demand. The higher market clearing price that would have been achieved would have raised more money for the issuer.

Another manifestation of such confusion of the means and ends of financial markets is the exercise of control on the flow of IPO by the relevant authorities in some jurisdictions by reference to stock market performance. When the secondary market, for whatever reasons, is experiencing a significant downward adjustment, the authorities respond by calling a halt to IPO activities. Orderly conditions in the primary market are of course important if it is to serve its essential function of financial intermediation on a sustainable basis, but it should be for fund raisers and investors and not the authorities to decide when this should take place. And the private interests of secondary market stakeholders should not be allowed to override the public interest of maintaining an uninterrupted and reliable channel of financial intermediation through the primary market. A similar, specific example of the confusion of means and ends is the temporary closure of the Hong Kong stock market in 1987 by the stock brokers who had the responsibility of operating it in order to protect their interests when the stock market fell sharply.

This confusion gets to be rather dangerous when the innovative efforts of highly remunerated financial experts in pursuing vested interests associated with activity in the secondary market involve the use of derivatives and structured products that are highly leveraged and complex, and that generates unfamiliar risks possibly of a systemic nature. Instead of enhancing liquidity or making price discovery more efficient in the secondary market, which many of the originators of these products cleverly claim are the objectives of their efforts, volatility is exacerbated, to the extent of quickly drying up liquidity when the markets come under stress. And consequently financial crises erupt, causing debilitating damage to the economy.

Joseph Yam

12 June 2017