

No need to be chewed up by the 'crunch'

When the world woke up to a new era, the term 'credit crunch' sounded like some kind of breakfast cereal. Everyone knows different now and there are lessons to be learned that ultimately could feed through to benefit both financial institutions and individuals alike, argues risk expert Bart Patrick, SAS UK.



At the risk of stating the blindingly obvious it pays to know how much you owe to other people, how much they owe you and to save up for a rainy day.

Truisms perhaps, but if global financial markets – and ordinary folk – had taken heed of them, the 'crunch' would have remained uneaten in its metaphorical cereal packet. The terms 'crunch' and 'sub-prime' – the debt crisis that started in the US – are now firmly ingrained into the lexicon of language used by financial institutions around the world, and the man in the street.

Shockwaves will ripple for a long time to come. In the UK it started with the Northern Rock debacle that saw customers queuing around the block to get their money out. The Treasury decided to, in effect, nationalise the bank to rescue ordinary savers and mortgage holders. Over in the US, it began when the stricken investment bank Bear Stearns was snapped up by J.P. Morgan for a bargain-basement \$2 a share, down from \$200 a share, and followed a disastrous weekend when \$3 billion was wiped off the value of the company.

The financial world tends to use euphemisms such as 'discontinuity' and 'consolidation' to describe the chaos in the markets and the dog-eat-dog approach to hoovering up ailing rivals. As most people now know only too well, the sub-prime crisis rocked the world because high-risk debt on the US housing market was wrapped up with other financial instruments and then traded globally.

Turmoil

The ensuing economic turmoil resulted in the banks lacking the confidence to go on lending to each other. Furthermore, individual banks cracked down on the loans they were prepared to make to their own customers.

House repossessions have rocketed and house prices have fallen. The Bank of England, shackled to keeping inflation low, has only been able to tinker with the interest rate but reductions have not been passed on to customers because financial institutions remain nervous.

The Governor, Mervyn King has poured cold water on suggestions that he should cut interest rates to kick-start the economy again and has warned of a recession to come. In the US, the Fed has agreed special lending terms for institutional lenders to shore things up but there are still dark mutterings about a 30s-style depression.

Effective controls

An atmosphere of complacency has certainly had a part to play in all this. Some institutions didn't have – and some still don't have – effective financial and systems controls in place to enable them to understand their existing positions, or risk, within the market.

Much has been written about the 'greedy' bonuses of £1 million plus awarded to traders during these difficult times. Whilst the man in the street – struggling to stay off the street and to keep a roof over his head – can hardly be expected to shed a tear, the facts are that thousands of City jobs are being axed and the City is the engine of the British economy.

Few ordinary folk can grasp that £1 million is a drop in a bucket compared to the trillions some of these guys deal with and no-one should begrudge a commensurate reward in a capitalist society.

With the banks struggling and staff losing their jobs, there seems to be a common underlying fault that applies to both bosses and the people who work for them. 'Short-termism' – for want of a better description – has let both sides down. When times are good, the institutions see little point in installing sophisticated systems that could help them anticipate and weather the changes we are suffering from now.

Equally the big bonus boys are rewarded on an annual basis rather than on a longer term, such as two or three years, that would better demonstrate their ability to consistently hit business and market objectives.

Confidence

Nationally, the Chancellor faces a tough job to restore confidence in the long-term stability of the country. People need to work and produce, and that stems from there being available cash for people to spend, and this, in turn, means credit availability rather than a crunch.

Sovereign Funds – cash from other governments – may be an answer. The Chinese, for example, have been saving whilst the UK has been spending and they, like the Russians and wealthy nations in the Middle East, are now in a position to make lucrative investments in weakened UK markets. Whether this is a good thing in the long term however remains to be seen.

It's a tough world out there but it's not all doom and gloom. There will be a different economic landscape at the end of this and markets will probably end up fitter, leaner and more fit for purpose. But the days when everyone could anticipate making shedloads of cash are over. Consolidation is inevitable and minnows will get swallowed up. Given that 85 per cent of all hedge funds are below \$1 billion, they are just a drop in the ocean.

Trust

Confidence and trust are qualities that are hard to sustain in turbulent times. The devil is in the data and financial institutions use vast quantities of data, but all the information in the world is useless unless it is delivered and used within the right time frame.

The 'time value' of information can be measured in milli-seconds. Many financial institutions use algorithms that trade and hunt for arbitrage in financial instruments. This sort of business is fast, even light speed. This calls into question the value of 'stress testing' their portfolios to see what changes in macroeconomic factors such as interest rates might have, but it's no good doing it over night – that's ancient history in a market trading in microseconds!

What's needed is an analytical approach that can operate real time in the "now" or predict future events rather than add to a mass of figures that are certainly going to be out of date before they are of use. What's the use in old news?

People tend to look to Government and new regulations in times of trouble. But the US is highly regulated with corporate governance laws such as Sarbanes-Oxley, but even this didn't help spot the crunch.

The crunch is going to be a good thing for companies with embedded analytical processes that help them to take a risk-based view of the market and to better understand where their liabilities are.

The winners in all this will be those who use accurate and timely data to act fast in today's depressed, fragmented and fiercely competitive markets.

Bart Patrick, Head of Insurance Practice, SAS UK.