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ECONOMISTS' OUTLOOK

Behaviour, Distress and Regulation

Simon Davies, Vice President, The Blackstone Group, London, UK

Behaviour and perception affect the market. In fact, there is often such a significant effect caused by market behaviour that the difference between market behaviour and market abuse is difficult to spot. This has been a constant theme for regulators the world over. This brief editorial seeks to consider some of the effects of behaviour on stress and distress in a business.

Cyclicality and credit as a scarce resource

One of the most difficult things to track down in the market is the abuse of it for improper gain. The Financial Services Authority (FSA) in the UK has been criticised on several occasions for not taking sterner or more effective action to prevent market abuse through meting out retribution on those who have been abusive. In a world where information travels in quantity at speed, it is difficult to keep track of everything and more difficult to disentangle messages to unearth whether or not they have originated from a proper or improper source and, if improper, where that source resides.

The business of 'shorting' has been a hot topic recently, especially in the UK, where the FSA has made moves to 'out' short sellers of shares, requiring disclosure of short positions in companies that are the subject of a rights issue. The heightened sense of urgency arises from the perceived systemic risk posed by the shorting of financial stocks and shares – the businesses with a close connection to the public.

As we saw with Northern Rock, the fact that everyone has a bank account (which is a loan to the bank) means that news generated about a retail bank can have a significant impact on its liquidity position if other borrowing sources are not available. Reporting of significant share price movements in the press have an effect on the behaviour of the individual who, in turn, can then have an effect on the financial destiny of a business.

To 'out' those who short sell shares in rights issue stocks and blame rumour-mongers and the press for the problems and then to look no further is to misunderstand the reasons for failure and the financial markets' woes currently. The provision of credit to individuals and institutions has become a relatively scarce resource having been an abundant one in the recent past – credit provision, like many other parts of the financial market, is cyclical – this should come as no surprise.

The consequences of battling for a scarce resource are that there will be institutions and individuals who do not receive new credit or have existing credit lines 'pulled'. Whether that is the public withdrawing their life savings or Lehman Brothers not being in a position to renew a revolving line of credit the result is the same – find an alternative source of funding, learn to live with less cash or perhaps even go bust.

Behaviour as a causal link in market pricing and distress

During the early 2000s, analysts criticised businesses for having 'fat' balance sheets, not working their assets, for conservative funding models, low leverage and retaining too much cash. Businesses with these characteristics were heavily discounted by the market – not for their prospects, but for their perceived inefficiencies.

Searching for value, a chief executive and his executive management team would often strive to 'improve' efficiencies – borrow to repurchase shares, sell and lease back assets, use cash to acquire or hand back to shareholders, reduce the cost of funding by refinancing in the short-term markets and so on. Behaviour driven, at least to an extent, by the market. The market would reward successful efforts and continuing earnings with a higher share price relative to peers. The executive would be aligned with that success, being compensated in part with awards of those shares.

All the time, the assumptions made which drove the business plan adapted to the changing market characteristics during an impressively consistent credit expansion phase. A principal assumption of many was that 'the financing would always be there'. Credit markets became consistently liquid and funding was consistently available. Financiers pushed the envelope of lending in seeking to satisfy the demand of their clients for 'paper', fuelled by the thought of another 'record year' and what that would mean for them. Echoes of 'while the music is playing, you have to keep dancing …' filter round.

Then the momentum swings from credit expansion to credit contraction. The reality that increased speed and volume of transactions has led to decreased care and attention becomes apparent. Exuberance becomes panic in the structured credit markets – the first to feel the effect of the change in behaviour – previously liquid markets for securities literally grind to a halt. Market value driven businesses – from hedge funds to financial institutions, begin to feel the effects of the change – hedge fund redemptions increase as losses mount and those short of capital to fund redemptions are forced to restructure or close, financial institutions struggle to raise new equity capital to protect their balance sheets from falling asset prices.

Technical market pricing leads the market, volatility increases and risk is re-priced – in a fashion that causes commentators to question whether there has been an over-compensation for risk. The behaviour 'required' for a business to be successful in the credit expansion phase makes life exponentially more difficult – *risk* has increased through the increase in the rate at which transactions were done as another 'record year' was achieved and the *rate* of suffering has increased for asset-light businesses with significant gearing and a skewed dependence on short-term financing. Business failure rates increase.

Behaviour as a causal link in the duration of the suffering

A decision is required by investors – take the loss or hold the investment? Many different investor-types have been making those decisions for well over a year. For a fundamental-driven credit investor, much of their investment portfolio looks 'oversold' against fundamentals – except that there isn't any selling going on. Technical pricing in the markets eventually rights itself, right? As Keynes said, 'the market can stay irrational for longer than you can stay solvent'. Attempting to bet on a 'righting' of the market often exacerbates the actual problem in hand – in the credit markets' case, illiquidity – by encouraging behaviour which causes the continuation of a phenomenon of which we wish to be rid.

A decision is made not to sell, but to wait. Nothing happens – banks hold credit assets on a 'hold to maturity' basis rather than a 'mark to market' basis and avoid a balance sheet write-down, hedge funds seek not to recognise a loss of a greater nature than the book value shown to investors, CLO funds simply seek the cash flows from the loans for the time being and are not market price driven. Behaviour drives an elongation of the duration of the suffering in the credit markets.

Behaviour, regulation and the socialisation of the losses

We feel a sense of injustice when someone profits from the failure of others, as short sellers of stocks and shares do. We worry about the potential systemic effects of the failure of a large financial institution. We rail against the speculation in the press, the rumours of financial distress and the general malaise. Yet we behave in a fashion which arguably increases the ability of those to profit, the potential for failure and the volatility upon which rumour and speculation are based. Why is that?

The financial change which has occurred over the past year or so has been significant. It has made a mockery of the status of parts that the financial world which, in itself, has caused people to point fingers – in various directions – trying to find one or more culpable parties for the particular crises occurring. However, rather than that, surely it would be better to understand the way in which the financial system currently allows us to behave, and then to seek to regulate the financial system in a fashion which affects that behaviour in a manner designed to temper that behaviour?

Various of the globe's financial regulators will be seeking to address the question of how to change regulation. Wholesale changes will be required, but this does not necessarily mean stricter, more prescriptive, legislation or a knee-jerk against the bonus culture of banking, but rather that the opposite should be considered. When we look at the way in which regulation seeks to motivate currently, a number of pro-cyclical features. The incentive to make money (the greed aspect to human behaviour) is not in itself a bad thing, but it needs to be given direction and limitations through regulation of activity – to seek to regulate the effect rather than the cause is a blunt and inaccurate tool.

Regulation of a particular market is a careful balancing act – regulation too loose will create risk of failure within the regulated market in question, regulation too tight will create risk of failure outside the regulated market in question. Let me give a pertinent example. A bank originates mortgages. It re-packages those mortgages – sells them to a special purpose vehicle. The special purpose vehicle is set up in a lightly-regulated or unregulated market. It borrows money in the capital markets to purchase the assets, issuing rated securities. The rating agency criteria and modelling effectively regulates the way in which the capital structure of the special purpose vehicle is established. The markets buy paper with a particular rating attached, having relied, to a greater or lesser extent, on that rating. The exercise is profitable for the bank, as fees are paid for structuring, arranging and executing the transaction which created the special purpose vehicle. The bank disposes of an asset, receiving cash and freeing up capital.

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The 'originate-to-distribute' model is found in almost every area of a bank's activities. It is one example of the function of regulation and the way in which it affects behaviour (among other things). It creates risk by motivating a behaviour which is rewarded for moving assets off-balance sheet, freeing up capital and earning fees at the same time. When arranging to purchase an asset or lend money, it motivates the thought 'can I sell this to the market?' long before the thought 'how do I protect myself/the asset owner against loss?' enters the mind. This, in extreme circumstances, promotes irresponsible behaviour and possibly worse.

When we seek to re-regulate the financial services industry, we must consider its form and substance. Questions must be considered as to the balance between prescriptive regulation and principles-based regulation. Rather than merely penalising an institution's capital base for holding an asset within a regulated environment, we must allow for a balance between the owning of an asset and the accountability and responsibility required to be assumed if that asset is bundled with others and sold into an unregulated market environment. Rating agencies must also understand the responsibility they assume if they provide a credit rating to an unregulated business or company and the way in which that rating will be used.

If we have a financial system that regulates so as to motivate institutions and the people who work for them in a responsible and accountable manner then we would not feel so aggrieved when short sellers make money. We blame the system, but for every short seller, there is a buyer. The injustice is that we have little choice on a global basis but to socialise the losses to a greater or lesser extent, rather than allow the market to mete out justice on those who have profited. Governments and their central banks are propping up and bailing out the system in spades – allowing all of us to pay for the excesses of the recent past.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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