

Looking Ahead: an Argument for Setting up the FDRC

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Many have been busy brainstorming how to contain the current financial crisis. Looking ahead past the immediate measures, I want to propose a measure that we can take today to save us future headaches. Initially, I wanted to phrase my argument as setting up “another FDA.” The new “Financial Derivative Administration” would be a distant cousin of the FDA — the U.S. Food and Drug Administration. At the least, it would have saved us space in the (already overburdened) acronym storage section of our brains. But I am not arguing for FDA-style regulation in this column. Rather than a regulator, I propose to establish the “Financial Derivative Risk Commission” (FDRC): an information-generating institution that would strengthen the financial system in the medium and long run.

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The analogy to the FDA, though, is not completely lost. Alex Blumberg, contributing editor for National Public Radio's “Planet Money,” noted that Credit Default Swaps (CDSs) are financial instruments known in the industry as “over-the-counter” instruments. This designation, however, is grossly misleading. Over-the-counter drugs must pass a stringent evaluation by the FDA before they are deemed innocuous enough to be sold without a medical prescription. Over-the-counter financial instruments are not traded in a public exchange, and CDSs proved to be anything but innocuous.

CDSs are, in principle, “credit insurance.” As a buyer of a CDS, I pay a premium to a financial intermediary (the seller) in order to have an underlying credit instrument (say, a corporate bond) “insured.” If the credit issuer defaults, I give the credit instrument to my counterparty in the CDS (the seller), who pays me its face value. We swap after the credit issuer defaults. One can buy into a CDS without actually owning the credit instrument. Many financial actors (e.g. school districts, pension funds) were trading in them, but we now know that few understood what

they were actually buying or selling. “Behind the curtain” financial instruments might be a more accurate label.

But CDSs are not the root of the problem, and are unlikely to be very problematic in the future now that the markets have learned what they actually are. Innovative, useful, but by definition risky financial instruments that are yet to be designed will be the ones causing the problem — unless we plan ahead today. And to set the record straight from the start: I am not pleading for regulation in this column. What I argue is that information in financial markets is a critical public good, and should be treated as such. Accountability is important, which is why I believe we need a public institution to enter the market.

THE PROBLEM

“**F**light to quality” is a common symptom of financial crises. Investors “flee” by dumping risky assets and acquiring what they consider to be safe assets. The fact that 90-day U.S. Treasury bonds have been trading at very low yields — 0.01% on Friday November 21, 2008 (source: Yahoo! Finance) — suggests

that it is happening today. Besides that, an important point lies behind the very high levels of the “TED spread” during this crisis (the TED spread is the difference between the 90-day LIBOR and the 90-day Treasuries yield). These levels are a tell-tale sign that the market has no idea what “quality” it can flee to, other than U.S. government bonds. Everything else is being treated as high risk, if traded at all. Ay, there’s the rub.

During the years of the credit boom, Collateralized Debt Obligations (CDOs) were given very high ratings by credit rating agencies. These CDOs, many of which contained sub-prime mortgages, are now referred to as “toxic waste.” Even today, disentangling the anatomy of any CDO is a daunting task. CDOs received high ratings partly because they were backed by CDSs, which were interpreted as insurance. Many financial actors were trading these instruments without realizing the kind of risks involved (David Kestenbaum’s story of four school districts in Wisconsin that invested two hundred million dollars on a “synthetic” CDO is eye-opening). In hindsight, it is clear that the avalanche of new derivatives on the heels of the housing boom were given generous ratings because of a moral-hazard problem. Each credit rating agency raced to be the one to rate a given derivative (for a profit), and

giving generous ratings today meant a higher likelihood of being picked tomorrow.

THE PROPOSAL

Risk assessment from an institution not guided by short-run profit maximization would have been very valuable at the onset of the financial derivative explosion. The new FDRC will identify and quantify the risks in the different financial instruments. It will serve as a credible signaling device to the market, by providing reliable information on a variety of fronts: verification of the capitalization rules for the issuing institutions, overall intrinsic risk of the type of instrument, measures of sensitiveness to systemic/ industry/ firm risk, and just about any other piece of information the market finds useful.

There has been quite serious discussion about stepping up regulation for many types of financial institutions. Some years ago, the argument against regulation in the financial markets was that financial players are sophisticated, well-informed, and smart, so regulation would only cause costly inefficiencies. I believe that this argument is still valid. Investors should be free to put their money wherever they see fit. A risk assessment by the FDRC will not be mandatory: the issuers of financial derivatives will pay for the FDRC “seal of approval” only if they deem its benefits larger than its cost.

Judging by the extent of flight to quality, they will. In the current state of disarray, investors have very little on which to base their valuation of the myriad of available financial derivatives. The assessment of the FDRC will afford investors, even in the very immediate future, a better idea of the yield/risk tradeoffs inherent in the different financial instruments. Many assets, now practically frozen, will then begin to be traded again, letting the market do what it does best when reliable information is available — price assets — thus restoring liquidity to the markets. Creating a well-informed FDRC will eliminate the moral hazard problem that private rating agencies cannot circumvent.

A GLOBAL INSTITUTION

Finally, a global problem requires a global solution and the leaders of the G-20 countries seem to agree. The FDRC would do best as a multinational institution. This does not mean that we need to wait for many governments to agree to set it up. Once one country takes the initiative to set up the FDRC (the U.S. being the obvious candidate), every investor will be able to benefit from better information. What we need to avoid is several national or regional agencies competing to give generous ratings like the private agencies did. Without competition, however, accountability and transparency are

paramount. Part of the problem today is that the valuation models of private rating agencies are proprietary and kept under wraps. These models, as we later learned, were completely off the mark completely missed the boat. They were almost exclusively backward-looking statistical models that considered factors like average failure rates as exogenous.

Now is the moment to look ahead; to wield our hindsight to illuminate our foresight. We must seize the opportunity to set up a better institutional framework around our financial system while political will and support is present. By providing crucial information about the structure of different assets and derivatives, the FDRC will serve to prevent future crises from being amplified by a spiral like the one we are hurtling down today.

REFERENCES AND FURTHER READING (AND LISTENING)

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