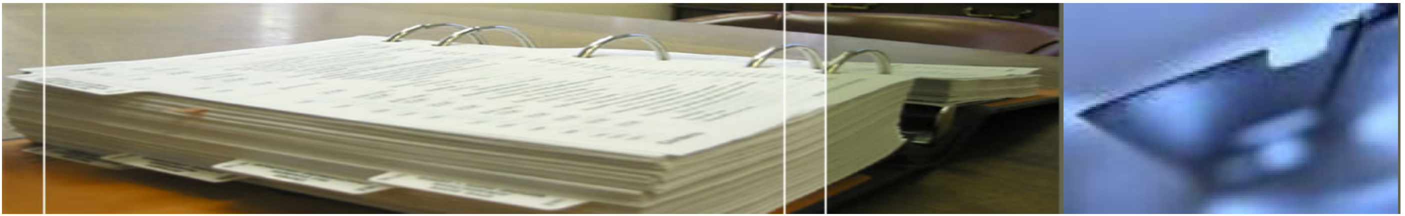

OCCAM RAZOR ALERT

Viewpoint: Reforms Should Address Correlation Risk
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By Isaac Lustgarten

The financial re-regulation process is under way. However, the evolving regulatory framework is already missing a crucial factor — the requirement to provide a regulator information to monitor and manage correlation risk.

In the last month, market players and regulators have offered hope of a better financial services system through improvements in three areas that reflected the weaknesses of our financial system: the credit ratings of structured products, the clearing of credit-default swaps, and the regulation of hedge funds. But the proposed improvements still do nothing to provide a regulator the information to measure and manage the likelihood that one kind of event would correlate to and affect another event.

Correlation risk arises when you buy a home prudently in a neighborhood of people who overborrowed to expand their houses in order to have a media room. When the price of fuel rises and your neighbors sell their unaffordable home, the value of your prudently purchased home goes down.

We need a system to help manage the risk that you will get hurt when others make bad investment decisions and take the wrong action. A regulator, like the Federal Reserve, charged to ensure the stability of the financial markets, must require the disclosure of information about the risk positions of a small group of large players (clearing houses, securitization vehicles, and hedge funds) or, if possible, the risk positions of a large group of small players (like the folks in your neighborhood who overbuilt their homes on borrowed money).

What would you do with this information about risk positions? In the housing context, you might move to a neighborhood where folks are buying homes where they can afford the renovations and the fuel. Or the government could impose caps on fuel prices. In the financial services context, a market stability regulator could require financial firms to post more collateral or raise capital when there is excessive borrowing or to reduce excessive correlated risk positions which, if unloaded quickly and simultaneously, could cause systemic problems.

Many wonder how the credit rating agencies could have been so wrong about the ratings assigned to asset securitizations. Credit ratings reflect a judgment of the creditworthiness of the issuer, not a judgment of the value of an investment. The credit ratings of securitized assets largely ignored systemic risk and the correlation between systemic risk and credit risks. Securitizing assets reduces the idiosyncratic risk of an asset but increases the asset pools' sensitivity to systemic risk. Because of their oligopoly, the credit rating agencies are in a unique position to know early about correlation risk among assets. The recent EU proposals and SEC rules for regulating credit rating agencies would require greater disclosure of data and methodologies, reduce conflicts of interests, differentiate ratings for complex products, enhance due diligence, shift the information burden to investors, and encourage more competition.

However, to improve the usefulness of ratings, a regulator needs to obtain access to correlation risk information as efficiently as possible from the rating agencies or force the rating agencies to consider the information as a factor in determining the credit risk of an issuer. This would provide governments a warning about possible systemic risks related to certain asset classes (for example that many investors are investing in assets that may go bad simultaneously, thereby affecting the creditworthiness of an issuer that holds such assets).

For dealing with credit-default swaps, a European exchange has just created a centralized counterparty clearing house, and three U.S. regulators are considering proposals to establish three different clearing houses. A centralized clearing house would mitigate (not eliminate) counterparty credit risk by imposing higher collateral, capital, and operational requirements on members, ensuring the existence of willing buyers and sellers, netting obligations, and substituting itself for the obligor in a credit-default swap.

Again, we need one regulator who will obtain from the clearing houses data to monitor the risk positions of credit-protection buyers and sellers in a standardized way. Moreover, a U.S. regulator and regulators in other major markets need to share such information. The FED, SEC and CFTC have agreed to share information about their clearing houses. But how does that data get aggregated when the questions and the answers are different?

Finally, again to enable the government and the markets to manage correlation risk, we need to create a database of hedge fund positions. (The Fed chairman in 2007 and most hedge fund managers in recent congressional hearings have supported this idea.) Regulators or a private company could aggregate the positions, analyze them, and compile the information in a statistical format that would not reveal the underlying hedge fund positions. The database manager would inform the public about when particular investment categories become illiquid. The regulators might, when a systemic risk arises, use the information to direct hedge funds or other large financial institutions to reduce categories of risk.

While our attention is focused on regulatory reform, we cannot afford to lose the opportunity to obtain the kind of information that would have signaled the weaknesses in the investment decisions made by our large financial firms. The moral hazard created by a government's playing these suggested roles in the financial markets is outweighed by the moral hazard created by a bailout.

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