



POST-RECESSION TOOLBOX: G20 AND THE NEW WORLD ORDER

The market is back

By Professor Arturo Bris – October 2009

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The reforms that are being put in place post-recession are looking set to change the financial world as we know it - in some ways dramatically.

As everyone begins to dust themselves off – albeit cautiously – people and corporations need to have a clear understanding of what these new proposals mean for individuals and corporations alike. What is the future of financial markets? What are the roles of hedge funds, investment banks, rating agencies - all pieces of the puzzle which, to a greater or lesser extent, have very much been seen as culprits of the 2007 crisis?

Across the world, voters are calling for new regulation to prevent further crises and naturally politicians have responded to the demands of voters.

Optimal regulation is where the market functions well. Currently, however, new regulatory structures appear to be interfering too much - and by interfering so much, may be having a negative effect on the market system as we know it, resulting in changes that were not intended.

Opportunism or regulation?

The Group of the 20 largest economies (G20) have recently met in Pittsburgh to discuss seven key action items to reform the financial system. Some, however, appear to be thinly veiled opportunism, which have little to do with the current financial crisis. Two of these are highlighted here.

The first is banking secrecy. This has been the centre of a big debate which actually has nothing to do with the recent financial crisis, but which has been used by regulators as an excuse.

Second, and more important, is the regulation of hedge funds. This is top of the G20 agenda. On this topic, several suggestions have been put forward. Top of the list is the new Directive on Alternative Investment Fund Management to be voted on by the European Parliament in the next few weeks. The Directive prevents any hedge fund that is not incorporated in a country with a tax treaty with the European Union to operate within the realms of the EU, with the outcome that 90% - 95 % of hedge funds will not be able to operate in Europe.

This will undoubtedly rule out certain agents that have played a negative role in the market. The side effects, however, will be dramatic. Hedge funds are a great opportunity with high return at - in good times - low risk. The Directive will erode valuable investment opportunities for European investors and corporations, for whom hedge funds play a very active role.

Hedge funds also play an important role as providers of liquidity. When hedge funds or financial institutions lose a lot of money, there is a liquidity freeze. For corporations, this means less credit. Less credit means less investment. Less investment means less growth. And less growth means less wealth for society – a difficult concept to sell to regular voters for whom hedge funds are only “the guys who took the money and ran.”

Rating agencies are among the prime culprits of the financial crisis and reforms are undoubtedly called for. This is not as simple as it may seem. Rating agencies play a valuable role by giving independent assessments of the riskiness of investment opportunities or companies. In their absence, a suitable alternative needs to be found. Currently, only increased transparency is on the G20 table as a solution to the problem. So far, proposals include the establishment of a supra-national rating agency - like the UEFA of the rating agencies, in a neutral country. This will rate all global financial products. Another option is to increase competition.

The G20 - “shop talker” or role definer?

So far, the G20 is just a declaration of good intent. If there is anything tangible, it is President Obama’s April plan with concrete proposals. The plan suggests that financial institutions should protect not only the interests of the shareholders but also the interests of customers. This means, in the extreme, that we will see financial institutions where not only shareholders, but customers as well, sit on the Board of Directors. This in itself would require a change in legislation that signifies a new capitalism.

Cash is king

Indirectly, regulation is changing companies’ appetite to take on debt. Companies that are borrowing less and have cash, or find imaginative, new ways of financing, are the winners.

In terms of equity issues, the outlook for the second half of 2009 is promising. As we stand now, the amount of issues of public securities is at an all-time record - both in terms of debt and equity.

While this doesn’t say anything about the real economy, the good news is that it means the market is back.

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