

IS 'SUB-PRIME' BRINGING A NEW BANKING WORLD ORDER?, PETER CORNELL

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The future stability of the Western financial markets may ultimately depend on adapting new approaches to remuneration, believes Peter Cornell of Terra Firma Capital Partners.

Quizás sea inevitable que tras valorar los últimos doce meses, muchas empresas y sus asesores jurídicos adopten una visión más prudente.

El *credit crunch* (crisis crediticia) es ya una realidad y, como nos han mostrado varios acontecimientos ocurridos en EE.UU. y Europa, es un asunto que nos afecta a todos.

Según Peter Cornell, es necesario un cambio en la regulación bancaria a nivel internacional. Afirmo que la crisis sub-prime, la complejidad de los productos y los préstamos para las *buyouts* (compras), caracterizados por ser muy agresivos, siguen teniendo, en cierta medida, la culpa de la situación actual.

No obstante, es significativo que también existan estructuras incentivadas en el área bancaria que han ayudado a sostener el empeño financiero de los bancos de inversión.

It is perhaps inevitable that when assessing the year ahead many businesses and their legal advisers will be adopting a cautious outlook.

The "credit crunch" is a reality and as recent events both in the US and across Europe have demonstrated, it is no longer an issue restricted exclusively to those with the most highly-leveraged debt portfolios.

The reclassification of even AAA-rated assets, and the potential for margin calls being made by creditors, demonstrates the continuing uncertainty that reaches throughout the finance sector – which is perhaps still dealing with only a fraction of the true potential credit losses. It may take until the end of the decade before the full scale of the crisis becomes apparent, with the losses incurred exceeding even the current worst estimates.

I believe a different approach to the global regulation of banks is required. Subprime mortgages, complex structured products and overly aggressive buyout lending continue to share the blame in different proportions for the current problems, but of significance also are the incentive structures in the banking arena that have helped to underpin the financial performance of many of the investment banks.

All companies need to incentivise their staff, and it is correct that those that deliver truly outstanding performance should be remunerated accordingly. In the financial world, this has meant providing a return that is better ("alpha") than the market would otherwise produce ("beta"), but without any relative increase in risk.

The last few years had seen investment banks deliver consistently high alpha performance, and pay their best-performing employees handsomely for it. However, as commoditisation began to be applied to the complex techniques that had initially delivered such "alpha" returns, the market began to catch up, and ever-more aggressive strategies and complex techniques were adopted.

What is now apparent is that such returns were not alpha, because while they were certainly good so was the risk associated with them. The remuneration problem is that while performance and incentive schemes may work on an annual cycle, risk does not. Annual bonuses are assessed only on the events over the preceeding year – and the same remuneration systems apply all the way up the management chain.

Employees continue to be incentivised to push limits, and to ultimately let somebody else worry about the consequences. As the recent intervention of the US and Western European central banks has demonstrated, when things go wrong it is the shareholders of the financial institutions and the taxpaying public that cover the final costs.

Longer-term compensation structures are required that take account of true performance and risk – leaving no incentive for the creation of short-term or illusionary "alpha". The future stability of the Western financial markets may ultimately depend on the adoption of more transparent performance and remuneration structures, for at stake is perhaps the continued dominance of the Western investment banks.

The rapid emergence in the last few years of sovereign wealth funds, notably those emanating from the oil-rich middle east, as well as Asia, brings with it the potential to create an alternative to the dominant western capital markets-led financial model.

The tremendous wealth held by such funds, coupled with their apparent longerterm investment horizon, provides a new and alternative source of international capital. The \$7.5bn stake in Citibank acquired by the Abu Dhabi Investment Authority, and the \$4.4bn acquisition of a stake in Merrill

Lynch by Singapore's Temasek Holdings have injected much-needed capital and demonstrated that liquidity is an issue for even the largest financial players.

With the International Monetary Fund estimating that sovereign funds have the potential to grow to between \$6-\$13 trillion by 2013, it is little wonder that businesses, and legal advisers, are increasingly turning their attention towards Asia and the middle east.

Peter Cornell is Managing Director, Stakeholder Relationships, at Terra Firma, and was previously Global Managing Partner of Clifford Chance.

This is an overview of informal comments given recently at Iberian Lawyer's Managing Partner Lunch: *Making Sense of Markets in Turmoil*. Other speakers included James Scoville, London managing partner of Debevoise & Plimpton and Norton Rose Chief Executive Peter Martyr.