Housing sector into a “systemic risk” for the entire financial system.

It is indeed mind-boggling that so many financial institutions allowed themselves—and were allowed by regulators—to be exposed so heavily to the housing sector, blindly assuming they were properly hedged. What can be done to prevent a recurrence of such cascading systemic risks?

The modern financial system has two pillars: a payment system via banking networks and a securities clearing mechanism via various organised exchanges and dealers. The current regulatory support system is tilted towards safeguarding the payment system with facilities like deposit insurance and central banks serving as lenders of last resort. These safety nets aren’t perfect, but we have witnessed how they worked in stabilising markets amid the current crisis. Due to the gravity of the situation, governments have expanded deposit insurance to cover more deposits, guaranteed inter-bank lending, and bought commercial paper directly.

An important part of the second pillar is organised exchanges through which stocks, bonds and some derivatives are traded. In the case of stocks and bonds, the role of exchanges is to facilitate transactions, and they do not take direct positions. Derivatives, foreign exchange rates and credit swaps allow long and short positions and seek to exploit relative price movements, with derivatives traders horizons being very short. However, the case of credit derivatives is different. The existence of credit derivatives, such as credit default swaps and CDSs, and credit default swaps (CDSs) and credit default swaps (CDSs) have been transformed into securities and sold. CDSs have been transformed into securities and sold as loans, thus increasing the risk of a financial crisis.

The systemic risk inherent in the OTC counterparty arrangements became evident in the near collapse of Bear Stearns and American International Group, and Lehman Brothers’ bankruptcy. It has been suggested that some of the OTC trading can be moved to an organised exchange. But it would be naive to think that organised exchanges can replace the OTC market. The current financial crisis forces us to recognise the vulnerability of this important pillar of the modern financial system.

The time has come to establish an international network of OTC market makers for their counterparty exposures, much like deposit insurance, but unlike domestic deposits in banks, counterparty transactions here can’t be collaterised by one jurisdiction. This guarantee should be global in nature and be funded by member states whose voting rights in the agency would be determined by the size of their contributions.

In exchange for the guarantee, OTC market makers would pay risk-based premiums to the guarantor. These premiums could be determined by a combination of quantitative and qualitative measures, much like the deposit insurance schemes that exist in many economies. Asian governments should seize this opportunity to take leadership in this global endeavour. One of the opinions that Singapore is an ideal location for this international guarantee agency.

Complacency tends to set in after any crisis is over. It is probably impossible to avoid future crises like the current. But at least we can try to reduce their frequency and contain the damage they cause once they occur. We need to implement better safeguards. This applies to Asian regulators, and the institutions under their supervision, as well as to European and American ones. Indeed, even more so because corporate governance in Asia is still weaker than in Europe or the US.

Wall Street will change as a result of this crisis. The broader trends indicate Asian economies are becoming stronger relative to the developed world. New and better ideas will emerge from Asian centres of finance.

I look forward to the day when that TV presenter in New York says: “Welcome to one of the world’s financial capitals.”

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