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2013 SYMPOSIUM PRESENTER'S DIARY: RESPONSES TO THE GLOBAL FINANCIAL CRISIS

By J. Scott Colesanti

It is not debated that the consequences of the global financial crisis—and responses thereto by varied governments—have been unprecedented. Canada's bailout is said to have topped $100 billion. Round one of the U.S. bailout alone cost more than $700 billion. And the European Union has now been described as spending $2 trillion in various forms of member state relief.

But a question garnering much less of a consensus centers on the fundamental causes of the crisis. Could a particular breed of investment vehicle simply have proven to be at once diabolically alluring and unquestionably toxic? Did storied Wall Street greed reach new proportions? Were regulators both under-resourced and outpaced by nimbler market participants? Or have events since the Fall of 2013 merely evidenced the perfect storm that provides uncharted swells every 100 years or so?

During the 2013 SOA Life and Annuity Symposium held in Toronto last month, I broached these and other questions on ideal regulatory

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reforms. My presentation offered as models the regulatory responses of Canada, the United States, and the European Union to three possible causes of the financial crisis: 1) concentration in over-the-counter (i.e., non-exchange traded) derivatives, 2) questionable imprimaturs by the major credit rating agencies, and 3) anonymous trading in "dark pools." This article both summarizes and supplements that presentation.

OTC DERIVATIVES

A considerable amount of regulatory response since 2009 has been focused on credit default swaps, the oft-blamed but seldom understood hedges to many CDO trading strategies of the last decade. The nearly uniform regulatory response of requiring "transparent" trading of these instruments on regulated exchanges or trading facilities is designed to, among other things, both increase competition and provide for better pricing.

Nearly five years after the onset of the crisis, final rules governing the new transparency remain debated. At first glance, the varied approaches to regulatory rulemaking provide some insight into the delay: The European Union employs an extra-territorial process that begins with the European Commission and often ends with legislative action at the Member State level. Canadian regulation, while driven by the Canadian Securities Administrators (CSA), might vary from province to province. Even the United States has seen relevant turf wars between Congress, the SEC, and the CFTC.

But the political promises of repeal of these reforms now appear quixotic, and mandatory measures aimed at greater disclosure are being rolled out in the United States and the European Union between 2013 and 2015. Meanwhile, in Canada, the provincial responses such as the Quebec Derivatives Act of 2009 have highlighted the need to provide exemptions for sophisticated entities serving as counterparties to the subject swap trades.

One audience member during my session opined that the press had recently reported that U.S. default swap trading today so nearly resembles pre-crisis levels that Wall Street employers are once again recruiting new graduates with an expertise in the field. Indeed, while the crisis succeeded in highlighting the almost unfathomable degree to which institutions trusted this business line, the practice continues on a weighty world scale.

CREDIT RATING AGENCIES

The Securities Exchange Commission was authorized by the Dodd-Frank Act of 2010 to require greater disclosures from nationally registered credit rating agencies. Subsequent Commission rulemaking mandated that the agencies, among other things, improve the quality of ratings and provide more transparency in attendant methodologies. But perhaps the more interesting reform contributed by Dodd-Frank paves the way for potential class actions against the agencies by private plaintiffs. Specifically, by eradicating its Rule 436(g) and concurrently clarifying the required proof of mental state for suits against agencies, the SEC invited the private class action Bar to the table set by Congress in 1933 for plaintiffs against issuers, underwriters, and broker-dealers.

Reforms in the European Union and Canada, while also guaranteeing agency registration and greater disclosure, do not similarly empower private plaintiffs. A pending EU reform asks commenters for feedback on whether fines against certain entities would deter misleading ratings.

A U.S. Department of Justice civil action from early 2013 did allege that a major rating agency overvalued CDOs in 2007, perhaps succeeding foremost in raising issues of timely government response than rating accuracy or earnestness. Overall, reforms to date have done little to alter the "issuer pays" model of compensation, while also stopping short of subjecting the agencies to the degree of oversight reserved for broker-dealers and issuing companies.

One audience commenter openly asked whether stricter regulation of the agencies is even possible, given the lack of the direct customer relationship that fuels broker-dealer supervision.

DARK POOLS

Earlier this year, *The New York Times* reported that such "off Board" trading may have peaked near 40 percent of the activity of some exchange listed issues in 2013. Nonetheless, there is no immediate plan for American regulators to fit that genie back into the bottle. Likewise, the operational requirements imposed by the EU on dark pools in recent years have actually been credited for their growth.

Canada alone has taken direct action to decrease the flow of trading away from established stock exchanges. CSA rules imposed in October 2012 obligate firms to demonstrate that customer trades filled internally were completed at a price commensurate with the market. Dark pool trading was said to have decreased in excess of 30 percent in the month immediately following, thus raising questions of whether greater regulation may succeed foremost in driving business to other markets.

CONCLUSION

To be sure, reasonable minds can differ on the wisdom of greater scrutiny of credit rating agencies, slowing the wave of off-board stock trading, and publishing details of credit derivative transactions akin to publically available information about stock trades. Questions of agency capture, the dearth of criminal penalties, and the lingering moral hazard occasioned by both add to the debate. What might best restore confidence in world markets would be closure on the present slate of reforms. In a nutshell, approaches—even where crystallized—remain somewhat undetailed and futuristic at present, perhaps precluding meaningful evaluation of results. After my presentation, I was of firmer conviction that measures such as Dodd-Frank need to be implemented with finality and publicized with force. As an old adage posits, Wall Street can handle anything except uncertainty itself.

J. Scott Colesanti, LL.M., is an Associate Professor at the Hofstra University Maurice A. Deane School of Law, where he has taught Securities Regulation since 2002. He can be reached at (516) 463-6413, j.s.colesanti@hofstra.edu