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Letters

Reputational risk may turn out the largest of all

From Mr Eric Knight.

Sir, The revelation of the way investment banks operate that has been highlighted by the Goldman Sachs case casts further light on the risks involved for banks (and their shareholders) in trading derivatives and brings into question the way these transactions are reflected in the accounts.

Almost exactly one year ago, we pointed out that derivatives account for more than 40 per cent of the balance sheet of many of the world's largest banks, but this is obfuscated by the fact that many banks offset derivative assets held for trading against related liabilities and only report the net figure ("Adjustments that flatter banks' capital strength", Letters, April 14 2009). This is still true today and in the case of some banks the gross

figure still accounts for well over 50 per cent of total assets.

The reason for pointing this out is that netting assets and liabilities in this way artificially reduces total assets and makes banks appear better capitalised than they really are in terms of equity to total assets. The counter-argument is that a perfectly matched set of transactions with the same counterparty bears no risk and can (effectively) be ignored. But this is rarely, if ever, the case. There is no free lunch and profits are only earned by taking some risk.

One of Britain's largest banks discloses in the notes to its accounts that its credit derivatives portfolio mostly consists of insurance sold on the senior tranches of a structured debt portfolio and insurance bought on the more junior (ie, most toxic) tranches of that same portfolio

This is clearly a massive and highly leveraged bet on a future decline in the value of the underlying credit portfolio and is ominously similar to the sort of transaction that has brought Goldman Sachs into the regulators' spotlight and the front pages of newspapers this week.

Regulators should not let themselves be swayed by such arguments. Trading in derivatives is a highly profitable – and highly risky – activity that should require substantial capital. However, even if this deficiency is corrected, reputational risk for the bank may turn out to be the largest risk of all.

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