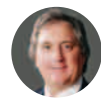
BACK TO BUSINESS



THE VIEW
RICHARD HARRIS

The cost of moral hazard

Rash investors and brokers need to remember that there can be harsh penalties for stupidity

In Switzerland in September, there was as yet no snow and the mountains were etched in the bright autumn sunlight. I could feel the clean air giving me energy after Hong Kong's polluted atmosphere – until I saw that the taxi fare was a breathtaking US$50.

Almost everything seemed to cost US$50 in Switzerland in 2011, as the world saw the Swiss franc as a currency haven, peaking at just 72 centimes to the US dollar compared to parity today.

Traders were stunned when the Swiss National Bank limited the rise in the franc to 1.20 to the euro, easing the pressure on the currency. I was just pleased that my return taxi would only cost US$40.

Traders were equally stunned when the central bank cut the limit last Thursday, causing a flurry of retail currency broker losses and defaults.

That the professionals were shocked a second time round shows both their naivety and that they were wilfully betting against the removal of the peg, known as Swexit. Either way, people who really should have known better were caught out in an obviously stupid manner.

This was never a cast iron peg like that of the Hong Kong dollar to the US dollar. The SNB saw it as a temporary measure to curb speculators, as a circuit breaker, and made no other commitment. It couldn't last, for in the last three years, a freely floating Swiss franc would surely have matched the US dollar's 18 per cent rise against the euro.

> **Regulators have to become more street smart in taking action before the event**

Market grown-ups always thought of Swexit as a case of when, and not if. The mere thought of being forever pegged to the euro would bring any respectable gnomes of Zurich out in an allergic rash.

It is not yet clear how these firms and their clients got themselves into trouble, but it is likely that they became involved with the risky carry trade. This sees a customer borrowing in Swiss francs at an extremely low interest rate, and investing in say European bonds or real estate for a higher return (plus the broker's commission). It appeared to provide a risk-free pickup, if the currencies don't move.

But if the currencies do move – and in this case the Swiss franc moved 20 per cent almost instantly – the borrowers find themselves paying that much extra back. They gained a miserable return of a per cent or two for the risk of losing tens of per cent. Exit the carry trade.

Brokers typically allow their customers to trade on margin, whereby they can deposit only the small amount of cash that they might reasonably expect to lose if things go wrong. In London, customers were said to hold positions 100 to 200 times the amount deposited. If the trade goes wrong, the customer loses his shirt and most other personal possessions – and can leave the broker carrying the debt.

There was a similar example of bad behaviour this week, but this time it was nipped in the bud. On Monday, the Shanghai stock market fell 7 per cent because three large Chinese brokerage houses were caught providing their customers with margin to take part in the recent market surge. The China Securities Regulatory Commission hit the miscreants where it hurt – by preventing them from opening new business for a while.

The SNB's decision to drop its peg shocked global markets. Photo: EPA

Margin trading and the carry trade are long established market practices among professionals and sometimes they have been successful. One online broker, who was ignominiously bailed out last week, continued to advertise "low commissions" on Monday. They encouraged retail investors to take part in "scalping" and "range-bound trading", activities best left to knowledgeable professionals. Such companies shelter behind long disclaimers that made my eyes water when I tried to read the tiny print.

The SNB and the CSRC taught rash investors about moral hazard; the assurance that if you take a big risk you will be properly punished if it goes wrong. Yet such failures imply that despite a lot of hard work, financial regulators are still not properly targeting potential market malpractice.

Regulators have to become more street smart in taking action before the event – not after a string of defaults. The heady mixture of debt combined with unsuitable clients can be observed, and warnings, trading bans, and restrictions on firms, individuals and management are all available for use. It's not easy, as regulators must make room for market evolution and creativity that can also make the system safer.

Market players themselves must better understand moral hazard; that in return for taking the big bucks, there are penalties for stupidity. Gone are the days when we used to glibly say in the broking business. "Market up, market down; put them in, take them out. Two commissions!"

Richard Harris is chief executive of Port Shelter Investment Management

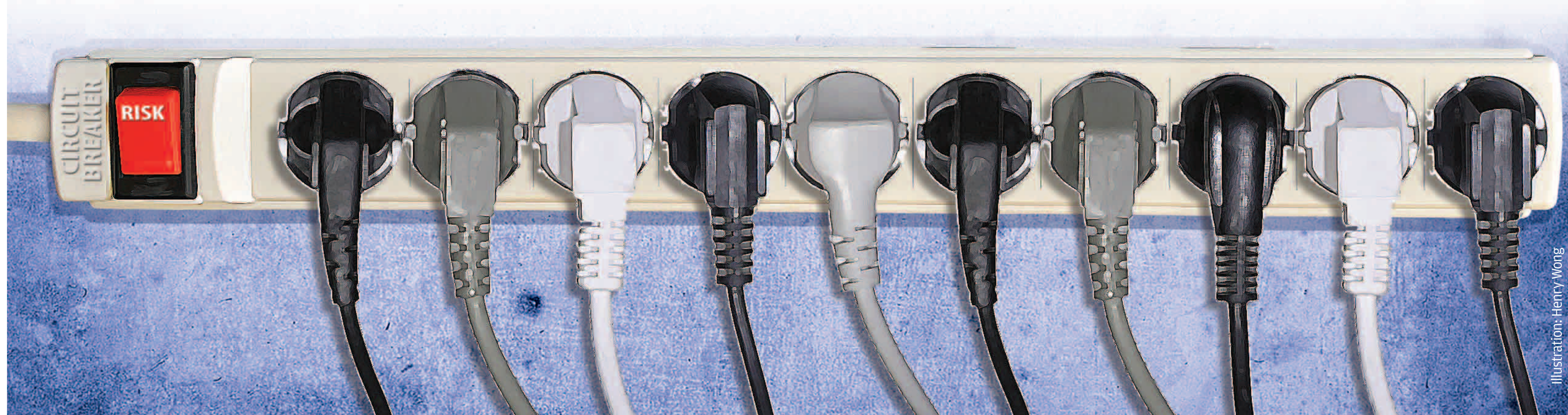


Illustration: Henry Wong