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CARRRESEARCH

# WHO PAYS WHEN HOMES FLOOD?

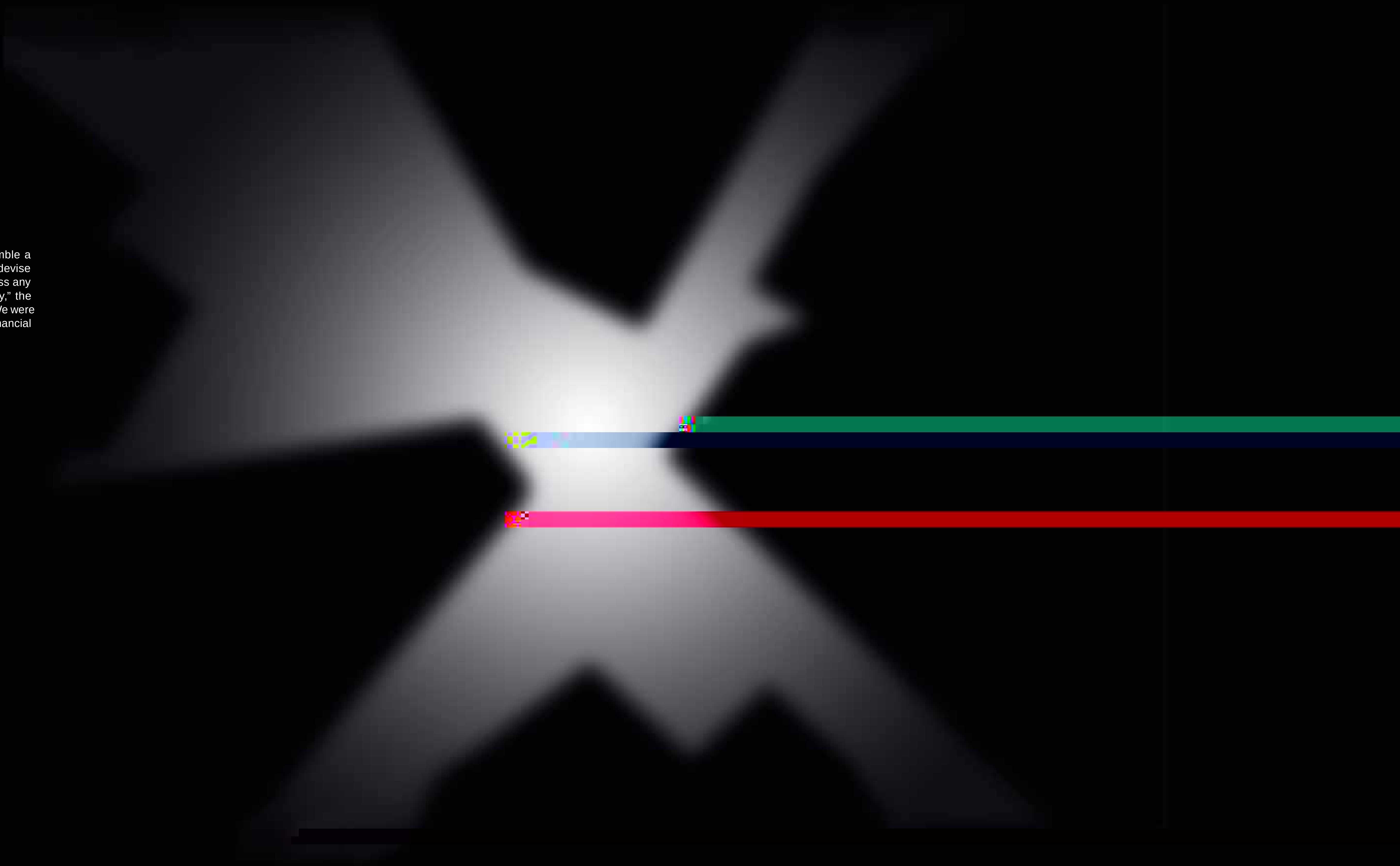
**Kristian Krieger and David Demeritt** discuss market solutions to flooding in response to this year's record breaking rainfall in the UK .

David Cameron's government has struggled to get a grip on the flooding caused by record rain which damaged almost 6,000 homes across England and left the Somerset Levels under water for months. The Prime Minister was heckled during a Boxing Day walkabout with flood victims in Kent when he donned his wellies to play commander-in-chief for the cameras. As ministers squabbled over who was to blame, the Army was dispatched to fill sandbags, and the Prime Minister repeatedly pledged, "money is no object".

The UK government has promised to provide all affected households and businesses with £5,000 "repair and renew" grants. It also suspended council taxes for affected properties, delayed business tax collections, and leaned on a number of government-owned banks bought up during the bailout to provide a £750 million package of interest-free loans.

Critics dismissed these measures as a pre-election give away to Tory voters. Having largely sat on its hand as Hull and other Labour strongholds on the east coast were flooded in

“It takes me about two hours to assemble a team of  nance geeks and lawyers to devise a product or a transaction that will bypass any new rule or regulation coming our way,” the senior French banker said over dinner. We were in Southern Europe at a conference on  nancial



# CARRRESEARCH

Under Basel III, banks stand to gain more by avoiding now heavier requirements.

monsters'. In other words, increased regulation is not necessarily the answer to wresting control of the shadow banking sector. The clear incentive to avoid regulation also suggests that it is not enough to blame the ideology of self-regulation (the consistent demand to not regulate on the grounds that market participants can protect themselves), for letting shadow banking go unchecked.

**Taylor Spears** examines some of Basel III's moving parts.

when the creditworthiness of its trading partners changes. For instance, if a bank has entered into a series of long-term derivatives contracts with a corporation, and the market's perception of the creditworthiness of that corporation deteriorates, then the CVA charge determines how much additional capital the bank must set aside to protect itself from changes in the value of its assets that arise from this increased risk of insolvency.

Until Basel III, the CVA capital charge was not an element of the accord. The Committee justi ed its decision to include CVA because nearly two-thirds of all credit-related losses during the  nancial crisis were caused by changes in the credit risk of trading partners, and not by partners' failure to pay the owed amounts. Asia Riska popular trade publication among derivatives traders and quants,

reports that many bankers believe the Committee's motivation was overtly political. They say it was designed to push "over-the-counter" derivatives trading onto centralised clearing houses so that counterparty risk would be reduced.

Ever since the CVA charge was proposed in 2009, banks have been sparring with regulators. They have been vigorously lobbying local authorities through the traditional channels to request special exemptions from the calculation. In July 2013, the European Banking Authority responded to these demands, permitting European banks to avoid CVA when they trade with pension funds, non- nancial corporations, and government entities. US banks are in a different boat. At the time of writing, US regulators are still refusing to grant any exemptions to the standard Basel CVA charge, much to the chagrin of major derivatives dealers.

Exemptions are one obvious moment of political wrangling in the world of  nancial regulation. There are, however, more fundamental issues at stake than deciding where and when CVA should be applied. A lesser noticed but arguably more divisive dispute is that banks and regulators cannot agree on how to mathematically de ne the CVA capital charge when it is employed for regulatory purposes.

Regulators often prefer using standardised formulas, because without an explicit statement of how capital should be calculated, there is little guarantee that measurements will be consistent across institutions. But according to many bankers, CVA can never be reduced to a single formula. The banks argue that CVA can only be accurately calculated using the internal risk management systems they've developed, which are built to suit each institution's particular style of risk management. Bankers further oppose standardized formulas because they tend to produce higher capital numbers. More conservative calculations may serve the public interest, but for banks, heavier capital requirements weaken pro tability.

Financial and political stakes meet smack in the details of how CVA gets calculated. Consider an asset that involves a series of payments between the bank and a corporation over several years.
A CVA represents a reduction to tcur.4(orm)-12.4(r)-5.1()-7.4(t(e)-20.o1 Tm [(A C)-03004 Tc 0.091 )-1.7(r-77(r-77(1(h)-15.4(e091 )-1.7(r-77(514.2

# THE UK'S SKY HIGH HOLIDAY PRICES

Is it really a surprise that prices for  ights and hotel accommodation become more expensive during school holidays? Not if we believe in the age old law of supply and demand. But when parents start pulling kids out of school because vacation packages are cheaper during term time, skyrocketing holiday prices becomes a national political problem.

Term-time holidaying is a common practice in the UK according to a recent poll conducted by ComRes for ITV News. Among parents with children under the age of 18, 35 per cent say they have already removed children from school, while another 51 per cent say they would do so if they could snag a cheaper holiday.

In February, the issue was brought to the attention of legislators who were asked to curb the damaging effects of price induced absenteeism on the education of British schoolchildren. One solution imposes  nes: parents may continue to take their kids out of school if they pay the £60 forfeit, per child. Another asks schools to simply break with tradition: by giving head teachers more autonomy to set their own term dates, holiday periods could be staggered, which is already the case in other European countries.

The UK's holiday debate raises an interesting question that rarely gets discussed: what are the social consequences of the way service providers set prices?

Pricing is a far more complicated process than the average consumer might think. In the tourism industry, the core of price formation is a technical system called "revenue management" (RM), also known as "yield management" in the airline industry. RM is especially

# CARROPINION

How does
France deal with
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# CARRNEWS

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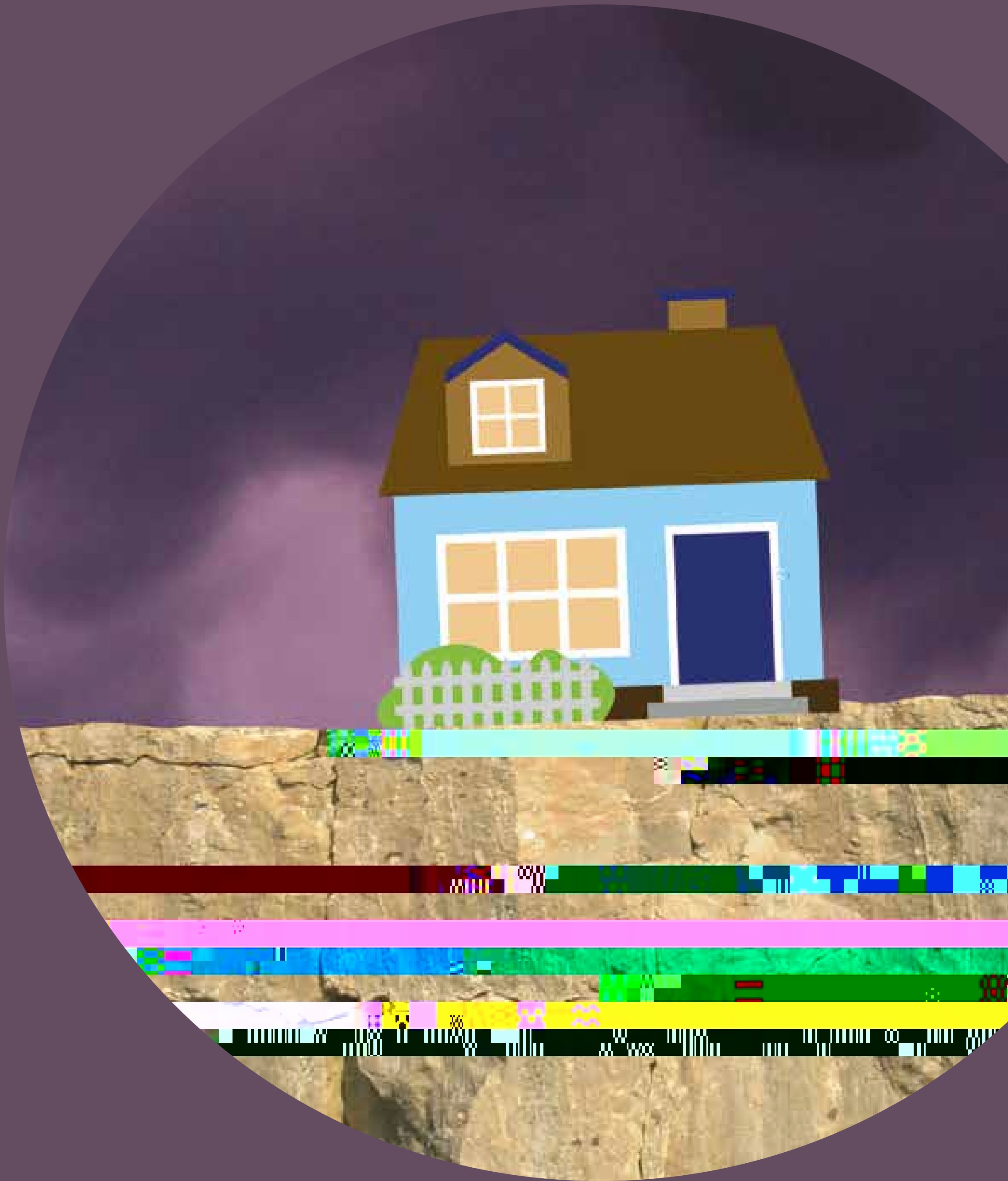
# CARRPEOPLE



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