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The Financial Crisis: Tax & Regulatory Arbitrage

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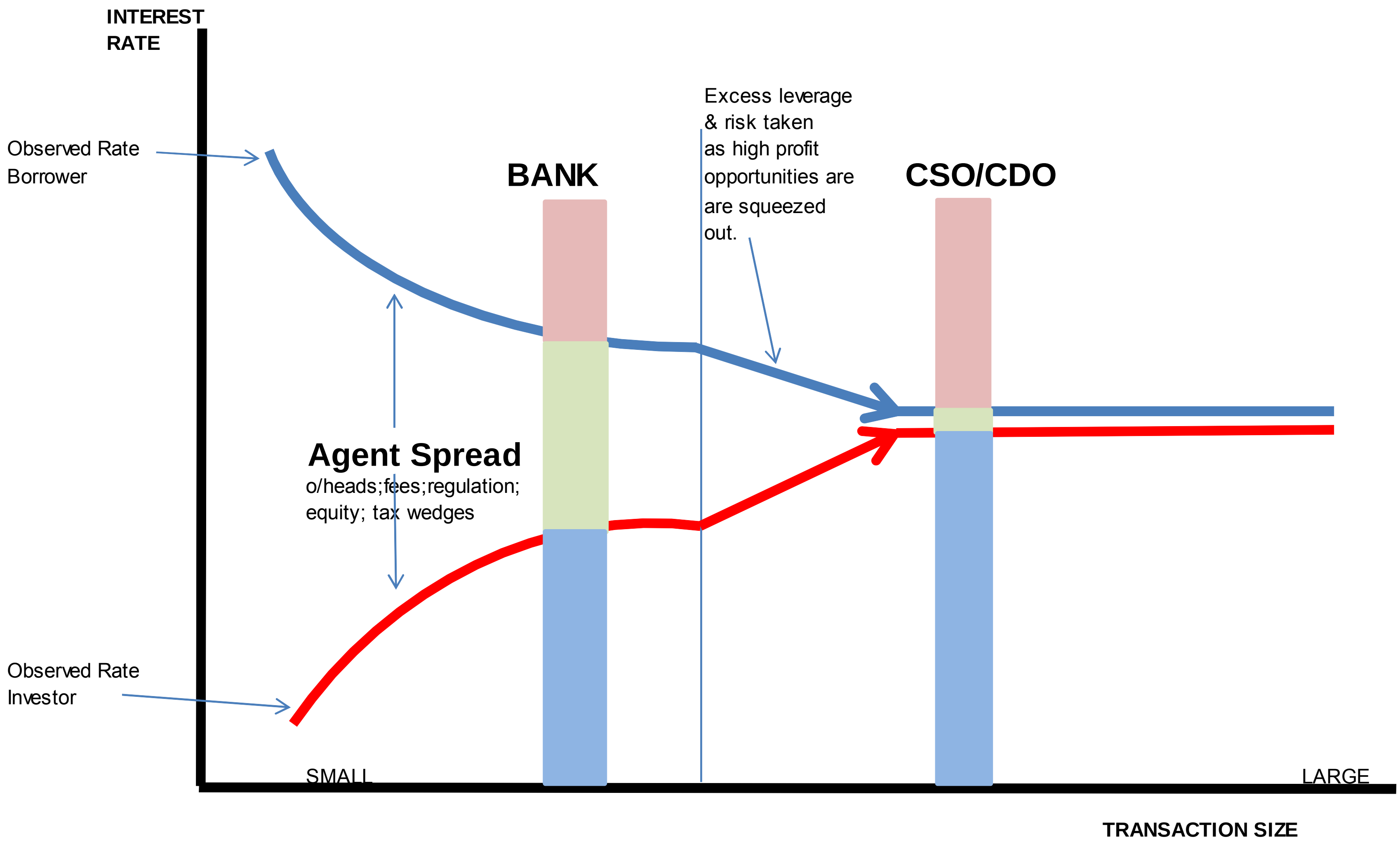
The Titanic

- Speeding to fast.
- A badly made ship, with no fully watertight compartments.
- Not enough life boats.
- Too big to sink

Hallmarks of the Crisis

- Its what banks do not how big they are.
- Contagion risk.
- Counterparty risk.

Fig. 1: The Arbitrage Process In Complete Markets For Credit—Promises Aren't Treated the Same



Source: Ironbridge Capital/OECD

Fig. 2: Tax Issues: Causal

- Tax deductibility of interest favours mortgages and corporate leverage.
- A key part of the private equity boom (gearing, taxing carried interest, etc).
- A key part of the growth in structured products. Structuring as capital gains. Structuring in a complete markets framework.
- Pass through (entity not taxed) to mortgage and other conduits (1986 reform in the US); synthetic leases.
- Infrastructure funds.

Fig. 3: TAX Arbitrage

	YIELD %	FACE VALUE		TAX STATUS % BOND H	TAX STATUS % BOND L
BOND H	10	1000	INVESTOR A	exempt	exempt
BOND L	8	1000	INVESTOR B	50	25

INVESTOR A	Short Bond L	-1000
	Long Bond H	1000
	Net postion	0
	Income Pick Up	20
	Return on investment	∞
INVESTOR B	Long Bond L	1000
	Short Bond H	-1000
	Income Pick Up	10
	Return on investment	∞

Source: Thomson, Federal Reserve, OECD

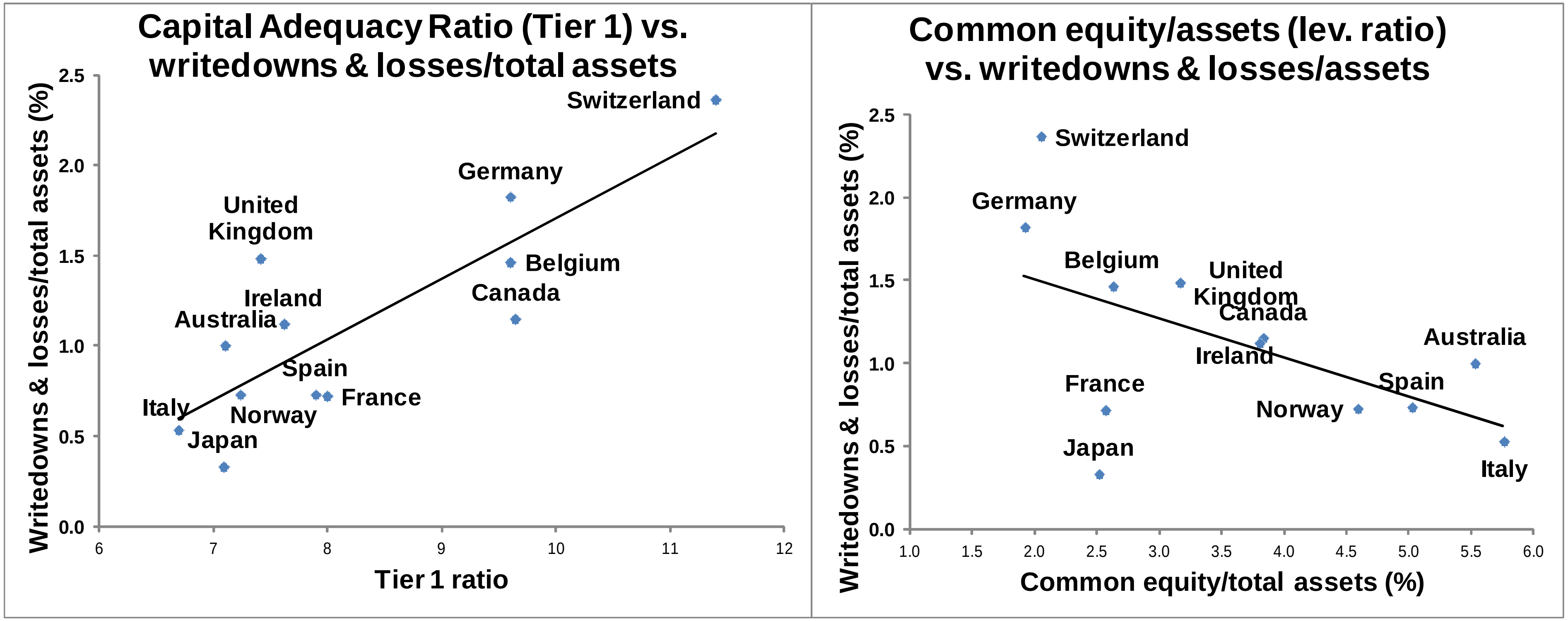
Fig. 4: Tax Leveraging & De-leveraging

- The tax-led boom in leverage led to de-equitisation in the 2000's; and now that process is being reversed with issuance and dilution of shareholders. Equity crash and overshoot.
- The crisis is leading to deleveraging—balance sheet reductions and asset sales. Debt deflation dynamics which is killing the economy.

Fig. 5: Shifting the Promises

Promise Transformations	Bond Face Value	Bank A 100% Cap Weight 8% Required K	Bank A 20% Cap Weight 8% Required K	Bank B Regulatory adjustment 50% Of B/sheet Wt. 1.5% surcharge coef & 8% Req K.
Bank A				
Face value BBB bond	1000	80		
Buy CDS on BBB bond from bank B			16	
Bank B				
Underwrites to Re-insurqnce $50 prem.				2.6
Total Banking Capital		**80**	**16**	**2.6**
Reinsurer		**?**	**?**	**?**

Fig. 6: Basel Capital Adequacy vs Leverage Ratio & Losses---Basel is Perverse

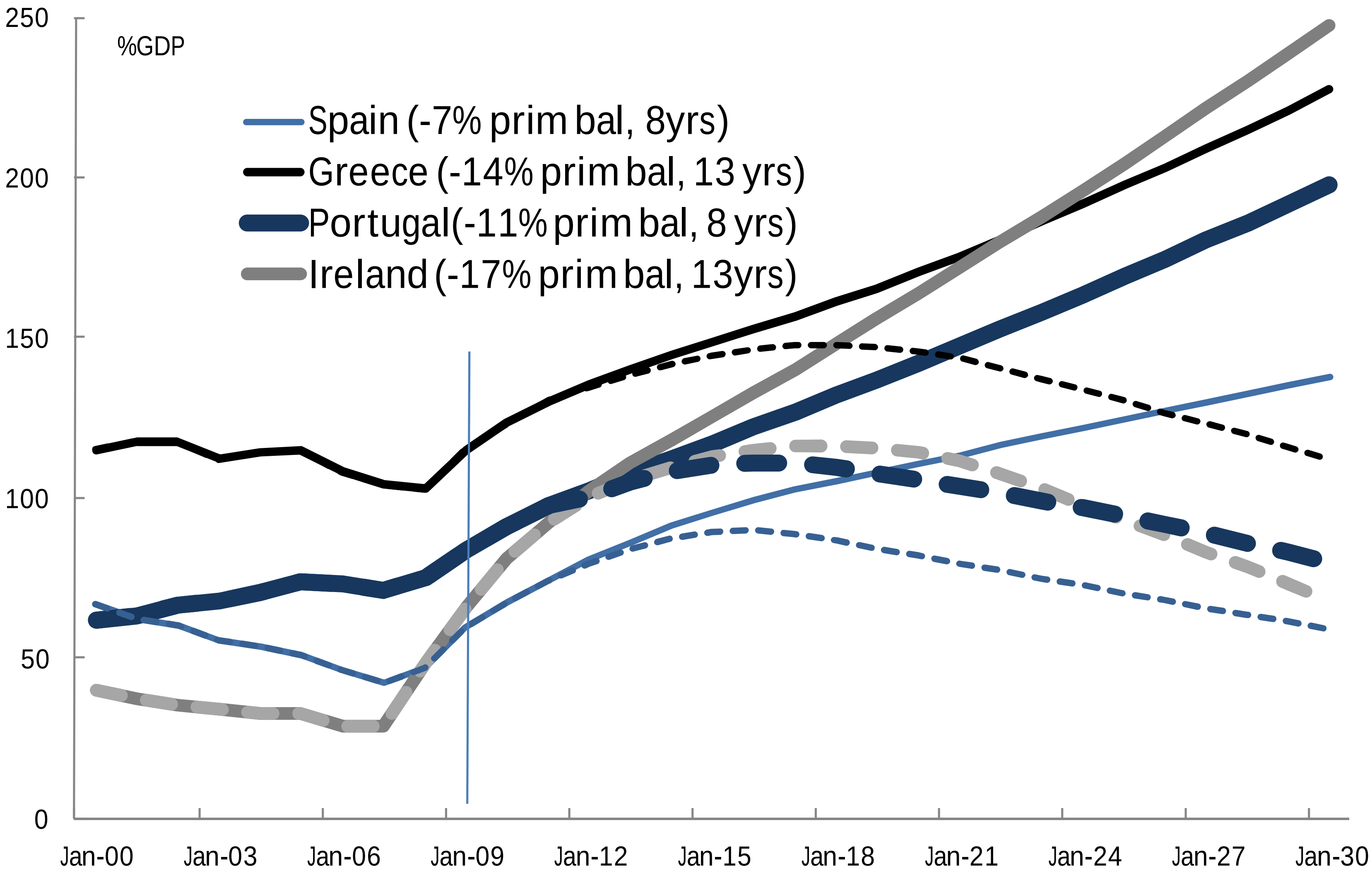


Source: , OECD; Thomson Reuters; Bloomberg, Worldscope, Datastream.
Cum. Losses Jan 2007 to mid 2009. Regulatory ratios 2006-2008 averages.

Fig. 7: Tax Issues: Paying For the Crisis

- Conservatively trillions of dollars are being spent and budget deficits have soared to levels thought unthinkable (10%+??).
- Taxes are going to have to rise to pay for it. But what forms of tax rises will best suit recovery and the type of investment we would like to see?

Fig. 8:Primary Budget Cuts Debt Projections



Source: , OECD, Datastream. .