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Market Comment

CLARMOND

The New Sun Kings Unmasked

The events of 2007-08 show how important collateral and its definition is to our financial system. The governments and central bankers are the sun kings of our times; let us hope they do not suffer a similar fate to the descendants of the previous Sun King, Louis XIV.

LOUIS XIV OF FRANCE, THE SUN king, during his 72 year reign increased his country's borrowing from 60 million livres to an eye-watering 3 billion. He died at the age of 77, however, the piper ultimately needed to be paid and it was his great-grandson, Louis XVI, during Europe's most dramatic revolution, who finally settled the account.

Today the world finds itself in another spiral of debt, in the middle of which sits King Collateral radiating out his credit-creating warmth to all commercial participants.

So what is collateral? Why is it important to us? The Oxford dictionary defines collateral as "property pledged as a guarantee for the repayment of money". Collateral is the keystone to modern finance as it is the mechanism used to create credit for all our business and financial uses. Increasing collateral equals surging credit; surging credit equals rising asset prices; rising asset prices equal content consumers with no revolutions imminent.

The new kid on the block

Half a century ago, gold was pre-eminent on the collateral podium, but now it has been replaced by 'AAA securities' or 'High Quality Collateral' (HQC). The key and obvious difference between gold and its successors is that the amount of gold can only be increased through physical engineering, whereas HQC can be rapidly and limitlessly increased through financial engineering.

HQC is described by the US Treasury as follows:

- 1) Hard currency cash;
- 2) A money-like asset;
- 3) Whatever the Central Bank dictates;
- 4) An asset not expected to depreciate; and
- 5) A security with a low haircut.

Only two institutions today create HQC - central banks via quantitative easing (QE) and governments via debt issuance.

QE effectively transforms "non-cash HQC into cash HQC" thus providing the vital collateral needed for the creation of credit.

Governments do the same by issuing government debt, which the US Treasury considers HQC. So the greater the budget deficit, the more HQC is created, which, in turn, is then available for credit creation. Therefore in our current financial system QE and government deficits create the HQC that provides the financial players the means to create credit and drive up asset prices. These are the rules of our game, night becomes day and the credit consuming world turns.

Collateral chains snap

Events of 2007-08 show what happened when King Collateral becomes reckless. Private sector AAA collateral of US mortgage-backed bonds were found to be wanting or worthless; the balance sheets of the majority of financial players were fatally flawed. When



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AAA was no longer AAA, the chains of collateral snapped and Governments and their central banks entered the fray to shore up the collapsing collateral, to protect the financial system and to prop up asset prices.

Still on the field

Today both government and central banks, the sun kings of credit, remain on the field; they are still the creators of credit and the drivers of asset prices. They may yearn for the day when their Dauphin, the private sector, once again starts to issue HQC. However, such was the disaster the last time this happened that this expectation seems forlorn.

As with Louis XIV the modern sun kings rule absolutely. We must all hope that the circularity of their collateral chain remains unchallenged, and as long as it does they can confidently repeat Louis's famous words:

"L'etat c'est moi". ■