



Jean-François SERVVAL, 1st September 2014

Article in French written by Laurent Chemineau, translation by Jean-Pascal Tranié

"Central banks, G20, and other authorities, all went into the same direction since the 2008 crisis: the regulation of finance". Looking back into these past *"post subprime"* six years, Jean-François Serval, president of Serval & Associates, co-writer with Jean-Pascal Tranié, president of Aloe Private Equity of "the monetary system: analysis and new approaches to regulation" (publisher Wiley), cannot hide his skepticism. In a financing world exposed to influential bank lobbies, Jean-François Serval underlines that this option is *"expensive and doesn't cure the issues"*.

The consequences are easily foreseeable: *"a proliferation of rules with multiple perverse effects"* regrets this heterodox and inventive independent auditor. "Excessive regulation can have a significant negative impact on the economy" in a framework characterized by excessive debts, deflationary pressure, protectionism temptations, and reduced economies of scale.

This warning is expressed as regulatory bodies encounter difficulties to encompass the multiple burgeoning financial institutions and vehicles (hedge funds, pension schemes, alternative asset vehicles, etc). *"Shadow banking has become a key component of rapidly growing monetary exchanges, as well as a significant source of money supply, uncontrolled by Central Banks, as underlined in my previous book, 'Virtual Money we live from' written with Jean-Pascal Tranié"* indicates the auditor, international managing partner from Constantin Associates CPA. Securitization transforms any asset into a tradable financial product. This is a source of sizable new sources of money, unaccounted for in monetary aggregates (M1, M2, M3). In addition, new regulations enforcing the role of economic agents such as central counterparties (clearing houses) pave the way for further systemic risks.

Governmental authorities should watch closely the velocity of money. In the United States, velocity of money ramped up in real estate due to excessive piling up of subprime loans and securitization" reminds Jean-François Serval. His diagnosis is adamant: lack of relevant tools prevent monetary authorities from controlling shadow banking. *"M1 and M2 have become obsolete due to disintermediated financing, which accounts for 75% of the sources of funds in the United States. Europe is less mature with only one third from disintermediated sources, but the trend is growing"*.

The authors have structured an innovative solution to measure these new financing sources, with two new monetary aggregates M5 and M6. "M5 could encompass the shadow banking and its counterparties, as it would cover bank loans as well as all receivables and payables classified according to their source, tradability, and the status of their issuer" explain the authors. This includes for instance, intercompany loans, or online payment from e-commerce trading platforms. If a credit default swap (CDS) held by a bank to cover its risk on the full amount of a Greek Sovereign debt trades at 80% of the par value, then M5 would take this 20% difference into account, which represents the execution risk on this coverage.

M6 would provide a valuation of the aggregated balance sheets of all economic agents (bonds, inventories, receivables, shares, liabilities, etc), enabling the measurement of money rotation for each category of financial instruments, through a reconciliation with the income statements." says Jean-François Serval.

This would have been the perfect tool to follow-up the development of CDS and their integration with the global economy, back in 2008. The comparison of M6 (the stock) with the income statements (the flows), highlight anomalies. When the assets of a balance sheet inflate without counterparties, the anomaly will appear in M6. Quantitative Easing (QE) direct consequence is a partial transfer of the corporation balance sheet risks to the Fed.

If discrepancies appear between M6 value at acquisition cost (i.e., the apparent value in the books) and the fair market value, problems will pop-up. Therefore, Jean-Francois Serval strongly recommends - *"focusing on a close and regular monitoring of the money aggregates and the flows of the economic agents instead of implementing a never-ending cycle of inefficient regulations"*.

Any counterpart of a transaction can be considered as money". The proposal aims to simplify and facilitate the representation of monetary flows, by economic agents and trade locations. *"Today, thanks to Big Data Computing, we will be able to spot abnormalities characterizing unstable situations ahead of crisis. Unstable situations are not bad as such, as they allow reallocation of resources. However, they must stay within reasonable acceptable social limits."*