

The
Economist



The gods strike back

A special report on financial risk | February 13th 2010



STARR UNDERWRITING AGENCIES, LLC

A SUBSIDIARY OF C.V. STARR & CO., INC.

Click to view video

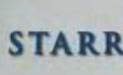


STARR UNDERWRITING AGENCIES, LLC

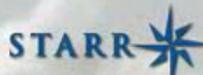
A SUBSIDIARY OF C.V. STARR & CO., INC.



C.V. STARR & COMPANY



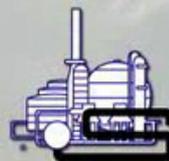
STARR GLOBAL ACCIDENT & HEALTH



STARR MARINE



STARR SPECIALTY LINES INSURANCE AGENCY, LLC



STARR TECH

Visit website

Sponsored by



STARR UNDERWRITING AGENCIES, LLC

A SUBSIDIARY OF C.V. STARR & CO., INC.

The gods strike back

Also in this section

Number-crunchers crunched

The uses and abuses of mathematical models. Page 3

Cinderella's moment

Risk managers to the fore. Page 6

A matter of principle

Why some banks did much better than others. Page 7

When the river runs dry

The perils of a sudden evaporation of liquidity. Page 8

Fingers in the dike

What regulators should do now. Page 10

Blocking out the sirens' song

Moneymen need saving from themselves. Page 13



Financial risk got ahead of the world's ability to manage it. Matthew Valencia asks if it can be tamed again

THE revolutionary idea that defines the boundary between modern times and the past is the mastery of risk: the notion that the future is more than a whim of the gods and that men and women are not passive before nature." So wrote Peter Bernstein in his seminal history of risk, "Against the Gods", published in 1996. And so it seemed, to all but a few Cassandras, for much of the decade that followed. Finance enjoyed a golden period, with low interest rates, low volatility and high returns. Risk seemed to have been reduced to a permanently lower level.

This purported new paradigm hinged, in large part, on three closely linked developments: the huge growth of derivatives; the decomposition and distribution of credit risk through securitisation; and the formidable combination of mathematics and computing power in risk management that had its roots in academic work of the mid-20th century. It blossomed in the 1990s at firms such as Bankers Trust and JPMorgan, which developed "value-at-risk" (VAR), a way for banks to calculate how much they could expect to lose when things got really rough.

Suddenly it seemed possible for any financial risk to be measured to five decimal places, and for expected returns to be adjusted accordingly. Banks hired hordes of PhD-wielding "quants" to fine-tune ever more complex risk models. The belief took hold that, even as profits were being boost-

ed by larger balance sheets and greater leverage (borrowing), risk was being capped by a technological shift.

There was something self-serving about this. The more that risk could be calibrated, the greater the opportunity to turn debt into securities that could be sold or held in trading books, with lower capital charges than regular loans. Regulators accepted this, arguing that the "great moderation" had subdued macroeconomic dangers and that securitisation had chopped up individual firms' risks into manageable lumps. This faith in the new, technology-driven order was reflected in the Basel 2 bank-capital rules, which relied heavily on the banks' internal models.

There were bumps along the way, such as the near-collapse of Long-Term Capital Management (LTCM), a hedge fund, and the dotcom bust, but each time markets recovered relatively quickly. Banks grew cocky. But that sense of security was destroyed by the meltdown of 2007-09, which as much as anything was a crisis of modern metrics-based risk management. The idea that markets can be left to police themselves turned out to be the world's most expensive mistake, requiring \$15 trillion in capital injections and other forms of support. "It has cost a lot to learn how little we really knew," says a senior central banker. Another lesson was that managing risk is as much about judgment as about numbers. Trying ever harder to capture ►►

Acknowledgments

In addition to those mentioned in the text, the author would like to thank the following for their help in preparing this report: Madelyn Antoncic, Scott Baret, Richard Bookstaber, Kevin Buehler, Jan Brockmeijer, Stephen Cecchetti, Mark Chauvin, John Cochrane, José Corral, Wilson Ervin, Dan Fields, Chris Finger, Bennett Golub, John Hogan, Henry Hu, Simon Johnson, Robert Kaplan, Steven Kaplan, Anil Kashyap, James Lam, Brian Leach, Robert Le Blanc, Mark Levonian, Tim Long, Blythe Masters, Michael Mendelson, Robert Merton, Jorge Mina, Mary Frances Monroe, Lubos Pastor, Henry Ristuccia, Brian Robertson, Daniel Sigris, Pietro Veronesi, Jim Wiener, Paul Wright and Luigi Zingales.

A list of sources is at

Economist.com/specialreports

An audio interview with the author is at

Economist.com/audiovideo

▶ risk in mathematical formulae can be counterproductive if such a degree of accuracy is intrinsically unattainable.

For now, the hubris of spurious precision has given way to humility. It turns out that in financial markets “black swans”, or extreme events, occur much more often than the usual probability models suggest. Worse, finance is becoming more fragile: these days blow-ups are twice as frequent as they were before the first world war, according to Barry Eichengreen of the University of California at Berkeley and Michael Bordo of Rutgers University. Benoit Mandelbrot, the father of fractal theory and a pioneer in the study of market swings, argues that finance is prone to a “wild” randomness not usually seen in nature. In markets, “rare big changes can be more significant than the sum of many small changes,” he says. If financial markets followed the normal bell-shaped distribution curve, in which meltdowns are very rare, the stockmarket crash of 1987, the interest-rate turmoil of 1992 and the 2008 crash would each be expected only once in the lifetime of the universe.

This is changing the way many financial firms think about risk, says Greg Case, chief executive of Aon, an insurance broker. Before the crisis they were looking at things like pandemics, cyber-security and terrorism as possible causes of black swans. Now they are turning to risks from within the system, and how they can become amplified in combination.

Cheap as chips, and just as bad for you

It would, though, be simplistic to blame the crisis solely, or even mainly, on sloppy risk managers or wild-eyed quants. Cheap money led to the wholesale underpricing of risk; America ran negative real interest rates in 2002-05, even though consumer-price inflation was quiescent. Plenty of economists disagree with the recent assertion by Ben Bernanke, chairman of the Federal Reserve, that the crisis had more to do with lax regulation of mortgage products than loose monetary policy.

Equally damaging were policies to promote home ownership in America using Fannie Mae and Freddie Mac, the country's two mortgage giants. They led the duo to binge on securities backed by shoddily underwritten loans.

In the absence of strict limits, higher leverage followed naturally from low interest rates. The debt of America's financial firms ballooned relative to the overall economy (see chart 1). At the peak of the madness, the median large bank had bor-

rowings of 37 times its equity, meaning it could be wiped out by a loss of just 2-3% of its assets. Borrowed money allowed investors to fake “alpha”, or above-market returns, says Benn Steil of the Council on Foreign Relations.

The agony was compounded by the proliferation of short-term debt to support illiquid long-term assets, much of it issued beneath the regulatory radar in highly leveraged “shadow” banks, such as structured investment vehicles. When markets froze, sponsoring entities, usually banks, felt morally obliged to absorb their losses. “Reputation risk was shown to have a very real financial price,” says Doug Roeder of the Office of the Comptroller of the Currency, an American regulator.

Everywhere you looked, moreover, incentives were misaligned. Firms deemed “too big to fail” nestled under implicit guarantees. Sensitivity to risk was dulled by the “Greenspan put”, a belief that America's Federal Reserve would ride to the rescue with lower rates and liquidity support if needed. Scrutiny of borrowers was delegated to rating agencies, who were paid by the debt-issuers. Some products were so complex, and the chains from borrower to end-investor so long, that thorough due diligence was impossible. A proper understanding of a typical collateralised debt obligation (CDO), a structured bundle of debt securities, would have required reading 30,000 pages of documentation.

Fees for securitisers were paid largely upfront, increasing the temptation to originate, flog and forget. The problems with bankers' pay went much wider, meaning that it was much better to be an employee than a shareholder (or, eventually, a taxpayer picking up the bail-out tab). The role of top executives' pay has been overblown. Top brass at Lehman Brothers and American International Group (AIG) suf-

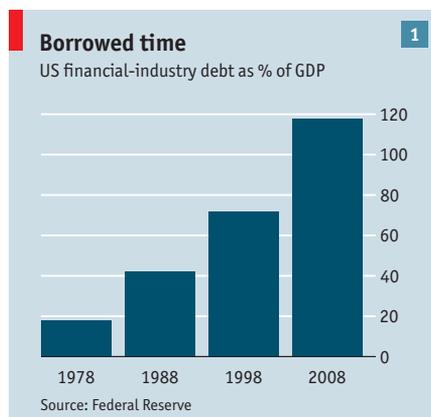
fered massive losses when share prices tumbled. A recent study found that banks where chief executives had more of their wealth tied up in the firm performed worse, not better, than those with apparently less strong incentives. One explanation is that they took risks they thought were in shareholders' best interests, but were proved wrong. Motives lower down the chain were more suspect. It was too easy for traders to cash in on short-term gains and skirt responsibility for any time-bombs they had set ticking.

Asymmetries wreaked havoc in the vast over-the-counter derivatives market, too, where even large dealing firms lacked the information to determine the consequences of others failing. Losses on contracts linked to Lehman turned out to be modest, but nobody knew that when it collapsed in September 2008, causing panic. Likewise, it was hard to gauge the exposures to “tail” risks built up by sellers of swaps on CDOs such as AIG and bond insurers. These were essentially put options, with limited upside and a low but real probability of catastrophic losses.

Another factor in the build-up of excessive risk was what Andy Haldane, head of financial stability at the Bank of England, has described as “disaster myopia”. Like drivers who slow down after seeing a crash but soon speed up again, investors exercise greater caution after a disaster, but these days it takes less than a decade to make them reckless again. Not having seen a debt-market crash since 1998, investors piled into ever riskier securities in 2003-07 to maintain yield at a time of low interest rates. Risk-management models reinforced this myopia by relying too heavily on recent data samples with a narrow distribution of outcomes, especially in sub-prime mortgages.

A further hazard was summed up by the assertion in 2007 by Chuck Prince, then Citigroup's boss, that “as long as the music is playing, you've got to get up and dance.” Performance is usually judged relative to rivals or to an industry benchmark, encouraging banks to mimic each other's risk-taking, even if in the long run it benefits no one. In mortgages, bad lenders drove out good ones, keeping up with aggressive competitors for fear of losing market share. A few held back, but it was not easy: when JPMorgan sacrificed five percentage points of return on equity in the short run, it was lambasted by shareholders who wanted it to “catch up” with zippier-looking rivals.

An overarching worry is that the com- ▶▶

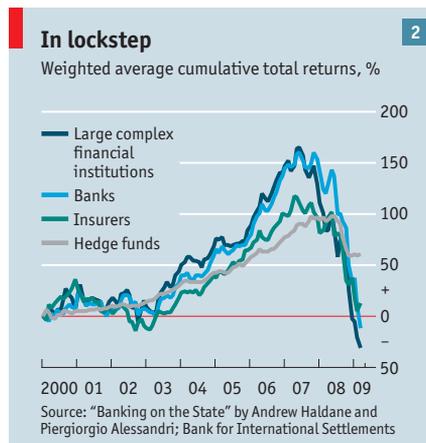


plexity of today's global financial network makes occasional catastrophic failure inevitable. For example, the market for credit derivatives galloped far ahead of its supporting infrastructure. Only now are serious moves being made to push these contracts through central clearing-houses which ensure that trades are properly collateralised and guarantee their completion if one party defaults.

Network overload

The push to allocate capital ever more efficiently over the past 20 years created what Till Guldemann, the father of VAR and vice-chairman of SunGard, a technology firm, calls "capitalism on steroids". Banks got to depend on the modelling of prices in esoteric markets to gauge risks and became adept at gaming the rules. As a result, capital was not being spread around as efficiently as everyone believed.

Big banks had also grown increasingly interdependent through the boom in derivatives, computer-driven equities trading and so on. Another bond was cross-ownership: at the start of the crisis, financial firms held big dollops of each other's common and hybrid equity. Such tight coupling of components increases the danger of "non-linear" outcomes, where a small change has a big impact. "Financial markets are not only vulnerable to black swans but have become the perfect breeding ground for them," says Mr Guldemann. In such a network a firm's troubles can have an exaggerated effect on the perceived riskiness of its trading partners. When Lehman's credit-default spreads



rose to distressed levels, AIG's jumped by twice what would have been expected on its own, according to the International Monetary Fund.

Mr Haldane has suggested that these knife-edge dynamics were caused not only by complexity but also—paradoxically—by homogeneity. Banks, insurers, hedge funds and others bought smorgasbords of debt securities to try to reduce risk through diversification, but the ingredients were similar: leveraged loans, American mortgages and the like. From the individual firm's perspective this looked sensible. But for the system as a whole it put everyone's eggs in the same few baskets, as reflected in their returns (see chart 2).

Efforts are now under way to deal with these risks. The Financial Stability Board, an international group of regulators, is trying to co-ordinate global reforms in areas

such as capital, liquidity and mechanisms for rescuing or dismantling troubled banks. Its biggest challenge will be to make the system more resilient to the failure of giants. There are deep divisions over how to set about this, with some favouring tougher capital requirements, others break-ups, still others—including America—a combination of remedies.

In January President Barack Obama shocked big banks by proposing a tax on their liabilities and a plan to cap their size, ban "proprietary" trading and limit their involvement in hedge funds and private equity. The proposals still need congressional approval. They were seen as energising the debate about how to tackle dangerously large firms, though the reaction in Europe was mixed.

Regulators are also inching towards a more "systemic" approach to risk. The old supervisory framework assumed that if the 100 largest banks were individually safe, then the system was too. But the crisis showed that even well-managed firms, acting prudently in a downturn, can undermine the strength of all.

The banks themselves will have to find a middle ground in risk management, somewhere between gut feeling and number fetishism. Much of the progress made in quantitative finance was real enough, but a firm that does not understand the flaws in its models is destined for trouble. This special report will argue that rules will have to be both tightened and better enforced to avoid future crises—but that all the reforms in the world will never guarantee total safety. ■

Number-crunchers crunched

The uses and abuses of mathematical models

IT PUT noses out of joint, but it changed markets for good. In the mid-1970s a few progressive occupants of Chicago's options pits started trading with the aid of sheets of theoretical prices derived from a model and sold by an economist called Fisher Black. Rivals, used to relying on their wits, were unimpressed. One model-based trader complained of having his papers snatched away and being told to "trade like a man". But the strings of numbers caught on, and soon derivatives exchanges hailed the Black-Scholes model, which used share and bond prices to calcu-

late the value of derivatives, for helping to legitimise a market that had been derided as a gambling den.

Thanks to Black-Scholes, options pricing no longer had to rely on educated guesses. Derivatives trading got a huge boost and quants poured into the industry. By 2005 they accounted for 5% of all finance jobs, against 1.2% in 1980, says Thomas Philippon of New York University—and probably a much higher proportion of pay. By 2007 finance was attracting a quarter of all graduates from the California Institute of Technology.

These eggheads are now in the dock, along with their probabilistic models. In America a congressional panel is investigating the models' role in the crash. *Wired*, a publication that can hardly be accused of technophobia, has described default-probability models as "the formula that killed Wall Street". Long-standing critics of risk-modelling, such as Nassim Nicholas Taleb, author of "The Black Swan", and Paul Wil-mott, a mathematician turned financial educator, are now hailed as seers. Models "increased risk exposure instead of limiting it", says Mr Taleb. "They can be worse ►►

▶ than nothing, the equivalent of a dangerous operation on a patient who would stand a better chance if left untreated.”

Not all models were useless. Those for interest rates and foreign exchange performed roughly as they were meant to. However, in debt markets they failed abjectly to take account of low-probability but high-impact events such as the gut-wrenching fall in house prices.

The models went particularly awry when clusters of mortgage-backed securities were further packaged into collateralised debt obligations (CDOs). In traditional products such as corporate debt, rating agencies employ basic credit analysis and judgment. CDOs were so complex that they had to be assessed using specially designed models, which had various faults. Each CDO is a unique mix of assets, but the assumptions about future defaults and mortgage rates were not closely tailored to that mix, nor did they factor in the tendency of assets to move together in a crisis.

The problem was exacerbated by the credit raters' incentive to accommodate the issuers who paid them. Most financial firms happily relied on the models, even though the expected return on AAA-rated tranches was suspiciously high for such apparently safe securities. At some banks, risk managers who questioned the rating agencies' models were given short shrift. Moody's and Standard & Poor's were assumed to know best. For people paid according to that year's revenue, this was understandable. “A lifetime of wealth was only one model away,” sneers an American regulator.

Moreover, heavy use of models may have changed the markets they were supposed to map, thus undermining the validity of their own predictions, says Donald MacKenzie, an economic sociologist at the University of Edinburgh. This feedback process is known as counter-performativity and had been noted before, for instance with Black-Scholes. With CDOs the models' popularity boosted demand, which lowered the quality of the asset-backed securities that formed the pools' raw material and widened the gap between expected and actual defaults (see chart 3).

A related problem was the similarity of risk models. Banks thought they were diversified, only to find that many others held comparable positions, based on similar models that had been built to comply with the Basel 2 standards, and everyone was trying to unwind the same positions at the same time. The breakdown of the models, which had been the only basis for pricing

the more exotic types of security, turned risk into full-blown uncertainty (and thus extreme volatility).

For some, the crisis has shattered faith in the precision of models and their inputs. They failed Keynes's test that it is better to be roughly right than exactly wrong. One number coming under renewed scrutiny is “value-at-risk” (VAR), used by banks to measure the risk of loss in a portfolio of financial assets, and by regulators to calculate banks' capital buffers. Invented by egg-heads at JPMorgan in the late 1980s, VAR has grown steadily in popularity. It is the subject of more than 200 books. What makes it so appealing is that its complex formulae distil the range of potential daily profits or losses into a single dollar figure.

Only so far with VAR

Frustratingly, banks introduce their own quirks into VAR calculations, making comparison difficult. For example, Morgan Stanley's VAR for the first quarter of 2009 by its own reckoning was \$115m, but using Goldman Sachs's method it would have been \$158m. The bigger problem, though, is that VAR works only for liquid securities over short periods in “normal” markets, and it does not cover catastrophic outcomes. If you have \$30m of two-week 1% VAR, for instance, that means there is a 99% chance that you will not lose more than that amount over the next fortnight. But there may be a huge and unacknowledged threat lurking in that 1% tail.

So chief executives would be foolish to rely solely, or even primarily, on VAR to manage risk. Yet many managers and boards continue to pay close attention to it without fully understanding the caveats—

the equivalent of someone who cannot swim feeling confident of crossing a river having been told that it is, on average, four feet deep, says Jaidev Iyer of the Global Association of Risk Professionals.

Regulators are encouraging banks to look beyond VAR. One way is to use CoVAR (Conditional VAR), a measure that aims to capture spillover effects in troubled markets, such as losses due to the distress of others. This greatly increases some banks' value at risk. Banks are developing their own enhancements. Morgan Stanley, for instance, uses “stress” VAR, which factors in very tight liquidity constraints.

Like its peers, Morgan Stanley is also reviewing its stress testing, which is used to consider extreme situations. The worst scenario envisaged by the firm turned out to be less than half as bad as what actually happened in the markets. JPMorgan Chase's debt-market stress tests foresaw a 40% increase in corporate spreads, but high-yield spreads in 2007-09 increased many times over. Others fell similarly short. Most banks' tests were based on historical crises, but this assumes that the future will be similar to the past. “A repeat of any specific market event, such as 1987 or 1998, is unlikely to be the way that a future crisis will unfold,” says Ken deRegt, Morgan Stanley's chief risk officer.

Faced with either random (and therefore not very believable) scenarios or simplistic models that neglect fat-tail risks, many find themselves in a “no-man's-land” between the two, says Andrew Freeman of Deloitte (and formerly a journalist at *The Economist*). Nevertheless, he views scenario planning as a useful tool. A firm that had thought about, say, the mutation of default risk into liquidity risk would have had a head start over its competitors in 2008, even if it had not predicted precisely how this would happen.

To some, stress testing will always seem maddeningly fuzzy. “It has so far been seen as the acupuncture-and-herbal-remedies corner of risk management, though perceptions are changing,” says Riccardo Rebonato of Royal Bank of Scotland, who is writing a book on the subject. It is not meant to be a predictive tool but a means of considering possible outcomes to allow firms to react more nimbly to unexpected developments, he argues. Hedge funds are better at this than banks. Some had thought about the possibility of a large broker-dealer going bust. At least one, AQR, had asked its lawyers to grill the fund's prime brokers about the fate of its assets in the event of their demise. ▶▶

Never mind the quality

CDOs of subprime-mortgage-backed securities
Issued in 2005-07, %

	Estimated 3-year default rate	Actual default rate
AAA	0.001	0.10
AA+	0.01	1.68
AA	0.04	8.16
AA-	0.05	12.03
A+	0.06	20.96
A	0.09	29.21
A-	0.12	36.65
BBB+	0.34	48.73
BBB	0.49	56.10
BBB-	0.88	66.67

Source: Donald MacKenzie, University of Edinburgh

Some of the blame lies with bank regulators, who were just as blind to the dangers ahead as the firms they oversaw. Sometimes even more so: after the rescue of Bear Stearns in March 2008 but before Lehman's collapse, Morgan Stanley was reportedly told by supervisors at the Federal Reserve that its doomsday scenario was too bearish.

The regulators have since become tougher. In America, for instance, banks have been told to run stress tests with scenarios that include a huge leap in interest rates. A supervisors' report last October fingered some banks for "window-dressing" their tests. Officials are now asking for "reverse" stress testing, in which a firm imagines it has failed and works backwards to determine which vulnerabilities caused the hypothetical collapse. Britain has made this mandatory. Bankers are divided over its usefulness.

Slicing the Emmental

These changes point towards greater use of judgment and less reliance on numbers in future. But it would be unfair to tar all models with the same brush. The CDO fiasco was an egregious and relatively rare case of an instrument getting way ahead of the ability to map it mathematically. Models were "an accessory to the crime, not the perpetrator", says Michael Mauboussin of Legg Mason, a money manager.

As for VAR, it may be hopeless at signaling rare severe losses, but the process by which it is produced adds enormously to the understanding of everyday risk, which can be just as deadly as tail risk, says Aaron Brown, a risk manager at AQR. Craig Broderick, chief risk officer at Goldman Sachs, sees it as one of several measures which, although of limited use individually, together can provide a helpful picture. Like a slice of Swiss cheese, each number has holes, but put several of them together and you get something solid.

Modelling is not going away; indeed, number-crunchers who are devising new ways to protect investors from outlying fat-tail risks are gaining influence. Pimco, for instance, offers fat-tail hedging programmes for mutual-fund clients, using cocktails of options and other instruments. These are built on specific risk factors rather than on the broader and increasingly fluid division of assets between equities, currencies, commodities and so on. The relationships between asset classes "have become less stable", says Mohamed El-Erian, Pimco's chief executive. "Asset-class diversification remains desir-



able but is not sufficient."

Not surprisingly, more investors are now willing to give up some upside for the promise of protection against catastrophic losses. Pimco's clients are paying up to 1% of the value of managed assets for the hedging—even though, as the recent crisis showed, there is a risk that insurers will not be able to pay out. Lisa Goldberg of MSCI Barra reports keen interest in the analytics firm's extreme-risk model from hedge funds, investment banks and pension plans.

In some areas the need may be for more computing power, not less. Financial firms already spend more than any other industry on information technology (IT): some \$500 billion in 2009, according to Gartner, a consultancy. Yet the quality of information filtering through to senior managers is often inadequate.

A report by bank supervisors last October pointed to poor risk "aggregation": many large banks simply do not have the systems to present an up-to-date picture of their firm-wide links to borrowers and trading partners. Two-thirds of the banks surveyed said they were only "partially" able (in other words, unable) to aggregate their credit risks. The Federal Reserve, leading stress tests on American banks last spring, was shocked to find that some of them needed days to calculate their expo-

sure to derivatives counterparties.

To be fair, totting up counterparty risk is not easy. For each trading partner the calculations can involve many different types of contract and hundreds of legal entities. But banks will have to learn fast: under new international proposals, they will for the first time face capital charges on the creditworthiness of swap counterparties.

The banks with the most dysfunctional systems are generally those, such as Citigroup, that have been through multiple marriages and ended up with dozens of "legacy" systems that cannot easily communicate with each other. That may explain why some Citi units continued to pile into subprime mortgages even as others pulled back.

In the depths of the crisis some banks were unaware that different business units were marking the same assets at different prices. The industry is working to sort this out. Banks are coming under pressure to appoint chief data officers who can police the integrity of the numbers, separate from chief information officers who concentrate on system design and output.

Some worry that the good work will be cast aside. As markets recover, the biggest temptation will be to abandon or scale back IT projects, allowing product development to get ahead of the supporting technology infrastructure, just as it did in the last boom.

The way forward is not to reject high-tech finance but to be honest about its limitations, says Emanuel Derman, a professor at New York's Columbia University and a former quant at Goldman Sachs. Models should be seen as metaphors that can enlighten but do not describe the world perfectly. Messrs Derman and Wilmott have drawn up a modeller's Hippocratic oath which pledges, among other things: "I will remember that I didn't make the world, and it doesn't satisfy my equations," and "I will never sacrifice reality for elegance without explaining why I have done so." Often the problem is not complex finance but the people who practise it, says Mr Wilmott. Because of their love of puzzles, quants lean towards technically brilliant rather than sensible solutions and tend to over-engineer: "You may need a plumber but you get a professor of fluid dynamics."

One way to deal with that problem is to self-insure. JPMorgan Chase holds \$3 billion of "model-uncertainty reserves" to cover mishaps caused by quants who have been too clever by half. If you can make provisions for bad loans, why not bad maths too? ■

Cinderella's moment

Risk managers to the fore

IN A speech delivered to a banking-industry conference in Geneva in December 2006, Madelyn Antonic issued a warning and then offered some reassurance. With volatility low, corporate credit spreads growing ever tighter and markets all but ignoring bad news, there was, she said, “a seemingly overwhelming sense of complacency”. Nevertheless, she insisted that the firm she served as chief risk officer, Lehman Brothers, was well placed to ride out any turbulence, thanks to a keen awareness of emerging threats and a rock-solid analytical framework.

Behind the scenes, all was not well. Ms Antonic, a respected risk manager with an economics PhD, had expressed unease at the firm's heavy exposure to commercial property and was being sidelined, bit by bit, by the firm's autocratic boss, Dick Fuld. Less than two months after her speech she was pushed aside.

Lehman's story ended particularly badly, but this sort of lapse in risk governance was alarmingly common during the boom. So much for the notion, generally accepted back then, that the quality of banks' risk regimes had, like car components, converged around a high standard. “The variance turned out to be shocking,” says Jamie Dimon, chief executive of JPMorgan Chase.

The banks that fared better, including his own, relied largely on giving their risk-managing roundheads equal status with the risk-taking cavaliers. That was not easy. In happy times, when risk seems low, power shifts from risk managers to traders. Sales-driven cultures are the natural order of things on Wall Street and in the City. Discouraging transactions was frowned upon, especially at firms trying to push their way up capital-markets league tables. Risk managers who said no put themselves on a collision course with the business head and often the chief executive too.

At some large banks that subsequently suffered big losses, such as HSBC and Royal Bank of Scotland (RBS), credit committees, which vetted requests for big loans, could be formed on an ad hoc basis from a pool of eligible members. If the committee's chairman, typically a business-line head, encountered resistance from a risk



manager or other sceptic, he could adjourn the meeting, then reconstitute the committee a week or two later with a more pliable membership that would approve the loan.

Another common trick was for a business line to keep quiet about a proposal on which it had been working for weeks until a couple of hours before the meeting to approve it, so the risk team had no time to lodge convincing objections. Exasperated roundheads would occasionally resort to pleading with regulators for help. In the years before the crash the Basel Committee of bank supervisors reportedly received several requests from risk managers to scrutinise excessive risk-taking at their institutions that they felt powerless to stop.

Many banks' failings exposed the triumph of form over substance. In recent years it had become popular to appoint a chief risk officer to signal that the issue was receiving attention. But according to Leo Grepin of McKinsey, “it was sometimes a case of management telling him, ‘you tick the boxes on risk, and we’ll worry about generating revenue’.”

Since 2007 banks have been scram-

bling to convince markets and regulators that they will continue to take risk seriously once memories of the crisis fade. Some are involving risk officers in talks about new products and strategic moves. At HSBC, for instance, they have had a bigger role in vetting acquisitions since the bank's American retail-banking subsidiary, bought in 2003, suffered heavy subprime-mortgage losses. “Everyone should now see that the risk team needs to be just as involved on the returns side as on the risk side,” says Maureen Miskovic, chief risk officer at State Street, an American bank.

Glamming up

Ms Miskovic is one of an emerging breed of more powerful risk officers. They are seen as being on a par with the chief financial officer, get a say in decisions on pay and have the ear of the board, whose agreement is increasingly needed to remove them. Some report directly to a board committee as well as—or occasionally instead of—to the chief executive.

For many, the biggest task is to dismantle cumbersome “silos”, says Ken Chalk of

A matter of principle

Why some banks did much better than others

▶ America's Risk Management Association. Risks were often stuffed into convenient but misleading pigeonholes. Banks were slow to refine their approach, even as growing market complexity led some of the risks to become interchangeable.

Take the growth of traded credit products, such as asset-backed securities and CDOs made up of them. Credit-risk departments thought of them as market risk, because they sat in the trading book. Market-risk teams saw them as credit instruments, since the underlying assets were loans. This buck-passing proved particularly costly at UBS, which lost SFr36 billion (\$34 billion) on CDOs. Many banks are now combining their market- and credit-risk groups, as HSBC did last year.

For all the new-found authority of risk managers, it can still be hard to attract talent to their ranks. The job is said to have the risk profile of a short option position with unlimited downside and limited upside—something every good risk manager should avoid. Moreover, it lacks glamour. Persuading a trader to move to risk can be “like asking a trapeze artist to retrain as an accountant”, says Barrie Wilkinson of Oliver Wyman, a consultancy.

A question of culture

Besides, there is more to establishing a solid risk culture than empowering risk officers. Culture is a slippery concept, but it matters. “Whatever causes the next crisis, it will be different, so you need something that can deal with the unexpected. That's culture,” says Colm Kelleher of Morgan Stanley. One necessary ingredient is a tradition of asking and repeating questions until a clear answer emerges, suggests Clayton Rose, a banker who now teaches at Harvard Business School.

The tone is set at the top, for better or worse. At the best-run banks senior figures spend as much time fretting over risks as they do salivating at opportunities (see box). By contrast, Lehman's Mr Fuld talked of “protecting mother” but was drawn to the glister of leveraged deals. Stan O'Neal, who presided over giant losses at Merrill Lynch, was more empire-builder than risk manager. But imperial bosses and sound risk cultures sometimes go together, as at JPMorgan and Banco Santander.

A soft-touch boss can be more dangerous than a domineering one. Under Chuck Prince, who famously learned only in September 2007 that Citigroup was sitting on \$43 billion of toxic assets, the lunatics were able to take over the asylum. Astonishingly, the head of risk reported not to Mr

JPMORGAN CHASE managed to avoid big losses largely thanks to the tone set by its boss, Jamie Dimon. A voracious reader of internal reports, he understands financial arcana and subjects staff to detailed questioning. PowerPoint presentations are discouraged, informal discussions of what is wrong, or could go wrong, encouraged. These “soft” principles are supplemented by a hard-headed approach to the allocation of capital. Though the bank suffered painful losses in leveraged loans, it was not tripped up by CDOs or structured investment vehicles (SIVs), even though it had been instrumental in developing both products. Nor was it heavily exposed to AIG, an insurance giant that got into trouble.

This was not because it saw disaster coming, says Bill Winters, former co-head of the firm's investment bank, but because it stuck by two basic principles: don't hold too much of anything, and only keep what you are sure will generate a decent risk-adjusted return. The bank jettisoned an SIV and \$60 billion of CDO-related risks because it saw them as too dicey, at a time when others were still keen to snap them up. It also closed 60 credit lines for other SIVs and corporate clients when it realised that these could be simultaneously drawn down if the bank's credit rating were cut. And it took a conservative view of risk-mitigation. Hedging through bond insurers, whose finances grew shaky as the crisis spread, was calculated twice: once assuming the hedge would hold, and again assuming it was worthless.

Goldman Sachs's risk management stood out too—unlike the public-relations skills it subsequently displayed. Steered by its chief financial officer, David Viniar, the firm's traders began reducing their exposure to mortgage securities months be-

fore subprime defaults began to explode. More willing than rivals to take risks, Goldman is also quicker to hedge them. In late 2006 it spent up to \$150m—one-eighth of that quarter's operating profit—hedging exposure to AIG.

The firm promotes senior traders to risk positions, making clear that such moves are a potential stepping stone to the top. Traders are encouraged to nurture the risk manager in them: Gary Cohn, the firm's president, rose to the top largely because of his skill at hedging “tail” risks. Crucially, Goldman generally does not fire its risk managers after a crisis, allowing them to learn from the experience. Yet despite everything, it still needed government help to survive.

By contrast, UBS's risk culture was awful. Its investment bank was free to bet with subsidised funds, since transfers from the private bank were deeply underpriced. It confused itself by presenting risk in a “net and forget” format. Trading desks would estimate the maximum possible loss on risky assets, hedge it and then record the net risk as minimal, inadvertently concealing huge tail risks in the gross exposure. And it moved its best traders to a hedge fund, leaving the B-team to manage the bank's positions.

Publicly humbled by a frank report on its failings, the bank has made a raft of changes. Risk controllers have been handed more power. Oswald Grübel, the chief executive, has said that if his new risk chief, Philip Lofts, rejects a transaction he will never overrule him. If the two disagree, Mr Lofts must inform the board, which no longer delegates risk issues to a trio of long-time UBS employees. A new, independent risk committee is bristling with risk experts. Whether all this amounts to a “new paradigm”, as Mr Lofts claims, remains to be seen.

Prince or the board, but to a newly hired executive with a background in corporate-governance law, not cutting-edge finance.

Another lesson is that boards matter too. Directors' lack of engagement or expertise played a big part in some of the worst slip-ups, including Citi's. The “sociology” of big banks' boards also had something to do with it, says Ingo Walter of New York's Stern School of Business: as the members bonded, dissidents felt pressure to toe the line.

Too few boards defined the parameters of risk oversight. In a survey last year De-

loitte found that only seven of 30 large banks had done so in any detail. Everyone agrees that boards have a critical role to play in determining risk appetite, but a recent report by a group of global regulators found that many were reluctant to do this.

Boards could also make a better job of policing how (or even whether) banks adjust for risk in allocating capital internally. Before the crisis some boards barely thought about this, naively assuming that procedures for it were well honed. A former Lehman board member professes himself “astonished”, in retrospect, at how ▶▶

▶ some of the risks in the company's property investments were brushed aside when assessing expected returns. The survivors are still struggling to create the sort of joined-up approach to risk adjustment that is common at large hedge funds, admits one Wall Street executive.

Board games

Robert Pozen, head of MFS Investment Management, an American asset manager, thinks bank boards would be more effective with fewer but more committed members. Cutting their size to 4-8, rather than the 10-18 typical now, would foster more personal responsibility. More financial-services expertise would help too. After the passage of the Sarbanes-Oxley act in 2002 banks hired more independent directors, many of whom lacked relevant experience. The former spymaster on Citi's board and the theatrical impresario on Lehman's may have been happy to ask questions, but were they the right ones?

Under regulatory pressure, banks such as Citi and Bank of America have hired more directors with strong financial-ser-

vices backgrounds. Mr Pozen suggests assembling a small cadre of financially fluent "super-directors" who would meet more often—say, two or three days a month rather than an average of six days a year, as now—and may serve on only one other board to ensure they take the job seriously.

That sounds sensible, but the case for another suggested reform—creating independent risk committees at board level—is less clear. At some banks risk issues are handled perfectly well by the audit committee or the full board. Nor is there a clear link between the frequency of risk-related meetings and a bank's performance. At Spain's Santander the relevant committee met 102 times in 2008. Those of other banks that emerged relatively unscathed, such as JPMorgan and Credit Suisse, convened much less often.

Moreover, some of the most important risk-related decisions of the next few years will come from another corner: the compensation committee. It is not just investment bankers and top executives whose pay structures need to be rethought. In the past, risk managers' pay was commonly

determined or heavily influenced by the managers of the trading desks they oversaw, or their bonus linked to the desks' performance, says Richard Apostolik, who heads the Global Association of Risk Professionals (GARP). Boards need to eliminate such conflicts of interest.

Meanwhile risk teams are being beefed up. Morgan Stanley, for instance, is increasing its complement to 450, nearly double the number it had in 2008. The GARP saw a 70% increase in risk-manager certifications last year. Risk is the busiest area for financial recruiters, says Tim Holt of Heidrick & Struggles, a firm of headhunters. When boards are looking for a new chief executive, they increasingly want someone who has been head of risk as well as chief financial officer, which used to be the standard requirement, reckons Mike Woodrow of Risk Talent Associates, another headhunting firm.

The big question is whether this interest in controlling risk will fizzle out as economies recover. Experience suggests that it will. Bankers say this time is different—but they always do. ■

When the river runs dry

The perils of a sudden evaporation of liquidity

STAMPEDING crowds can generate pressures of up to 4,500 Newtons per square metre, enough to bend steel barriers. Rushes for the exit in financial markets can be just as damaging. Investors crowd into trades to get the highest risk-adjusted return in the same way that everyone wants tickets for the best concert. When someone shouts "fire", their flight creates an "endogenous" risk of being trampled by falling prices, margin calls and vanishing capital—a "negative externality" that adds to overall risk, says Lasse Heje Pedersen of New York University.

This played out dramatically in 2008. Liquidity instantly drained from securities firms as clients abandoned anything with a whiff of risk. In three days in March Bear Stearns saw its pool of cash and liquid assets shrink by nearly 90%. After the collapse of Lehman Brothers, Morgan Stanley had \$43 billion of withdrawals in a single day, mostly from hedge funds.

Bob McDowall of Tower Group, a consultancy, explains that liquidity poses "the most emotional of risks". Its loss can prove

just as fatal as insolvency. Many of those clobbered in the crisis—including Bear Stearns, Northern Rock and AIG—were struck down by a sudden lack of cash or funding sources, not because they ran out of capital.

Yet liquidity risk has been neglected. Over the past decade international regulators have paid more attention to capital. Banks ran liquidity stress tests and drew up contingency funding plans, but often half-heartedly. With markets awash with cash and hedge funds, private-equity firms and sovereign-wealth funds all keen to invest in assets, there seemed little prospect of a liquidity crisis. Academics such as Mr Pedersen, Lubos Pastor at Chicago's Booth School of Business and others were doing solid work on liquidity shocks, but practitioners barely noticed.

What makes liquidity so important is its binary quality: one moment it is there in abundance, the next it is gone. This time its evaporation was particularly abrupt because markets had become so joined up. The panic to get out of levered mortgage in-

vestments spilled quickly into interbank loan markets, commercial paper, prime brokerage, securities lending (lending shares to short-sellers) and so on.

As confidence ebbed, mortgage-backed securities could no longer be used so easily as collateral in repurchase or "repo" agreements, in which financial firms borrow short-term from investors with excess cash, such as money-market funds. This was a big problem because securities firms had become heavily reliant on this market, tripling their repo borrowing in the five years to 2008. Bear Stearns had \$98 billion on its books, compared with \$72 billion of long-term debt.

Even the most liquid markets were affected. In August 2007 a wave of selling of blue-chip shares, forced by the need to cover losses on debt securities elsewhere, caused sudden drops of up to 30% for some computer-driven strategies popular with hedge funds.

Liquidity comes in two closely connected forms: asset liquidity, or the ability to sell holdings easily at a decent price; and ▶▶

▶ funding liquidity, or the capacity to raise finance and roll over old debts when needed, without facing punitive “haircuts” on collateral posted to back this borrowing.

The years of excess saw a vast increase in the funding of long-term assets with short-term (and thus cheaper) debt. Short-term borrowing has a good side: the threat of lenders refusing to roll over can be a source of discipline. Once they expect losses, though, a run becomes inevitable: they rush for repayment to beat the crowd, setting off a panic that might hurt them even more. “Financial crises are almost always and everywhere about short-term debt,” says Douglas Diamond of the Booth School of Business.

Banks are founded on this “maturity mismatch” of long- and short-term debt, but they have deposit insurance which reduces the likelihood of runs. However, this time much of the mismatched borrowing took place in the uninsured “shadow” banking network of investment banks, structured off-balance-sheet vehicles and the like. It was supported by seemingly ingenious structures. Auction-rate securities, for instance, allowed the funding of stodgy municipal bonds to be rolled over monthly, with the interest rate reset each time.

The past two years are littered with stories of schools and hospitals that came a cropper after dramatically shortening the tenure of their funding, assuming that the savings in interest costs, small as they were, far outweighed the risk of market seizure. Securities firms became equally complacent as they watched asset values rise, boosting the value of their holdings as collateral for repos. Commercial banks increased their reliance on wholesale funding and on fickle “non-core” deposits, such as those bought from brokers.

Regulation did nothing to discourage this, treating banks that funded themselves with deposits and those borrowing overnight in wholesale markets exactly the same. Markets viewed the second category as more efficient. Northern Rock, which funded its mortgages largely in capital markets, had a higher stockmarket rating than HSBC, which relied more on conventional deposits. The prevailing view was that risk was inherent in the asset, not the manner in which it was financed.

At the same time financial firms built up a host of liquidity obligations, not all of which they fully understood. Banks were expected to support off-balance-sheet entities if clients wanted out; Citigroup had to take back \$58 billion of short-term securities from structured vehicles it sponsored.



AIG did not allow for the risk that the insurer would have to post more collateral against credit-default swaps if these fell in value or its rating was cut.

Now that the horse has bolted, financial firms are rushing to close the door, for instance by adding to liquidity buffers (see chart 4). British banks’ holdings of sterling liquid assets are at their highest for a decade. Capital-markets firms are courting deposits and shunning flighty wholesale funding. Deposits, equity and long-term debt now make up almost two-thirds of Morgan Stanley’s balance-sheet liabilities, compared with around 40% at the end of 2007. Spending on liquidity-management systems is rising sharply, with specialists “almost able to name their price”, says one banker. “Collateral management” has become a buzzword.

Message from Basel

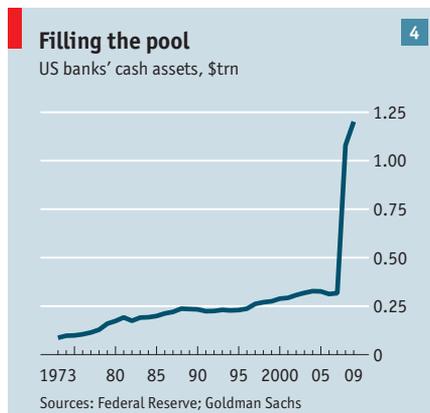
Regulators, too, are trying to make up for lost time. In a first attempt to put numbers on a nebulous concept, in December the Basel Committee of central banks and supervisors from 27 countries proposed a

global liquidity standard for internationally active banks. Tougher requirements would reverse a decades-long decline in banks’ liquidity cushions.

The new regime, which could be adopted as early as 2012, has two components: a “coverage” ratio, designed to ensure that banks have a big enough pool of high-quality, liquid assets to weather an “acute stress scenario” lasting for one month (including such inconveniences as a sharp ratings downgrade and a wave of collateral calls); and a “net stable funding” ratio, aimed at promoting longer-term financing of assets and thus limiting maturity mismatches. This will require a certain level of funding to be for a year or more.

It remains to be seen how closely national authorities follow the script. Some seem intent on going even further. In Switzerland, UBS and Credit Suisse face a tripling of the amount of cash and equivalents they need to hold, to 45% of deposits. Britain will require all domestic entities to have enough liquidity to stand alone, unsupported by their parent or other parts of the group. Also controversial is the composition of the proposed liquidity cushions. Some countries want to restrict these to government debt, deposits with central banks and the like. The Basel proposals allow high-grade corporate bonds too.

Banks have counter-attacked, arguing that “trapping” liquidity in subsidiaries would reduce their room for manoeuvre in a crisis and that the buffer rules are too restrictive; some, unsurprisingly, have called for bank debt to be eligible. Under the British rules, up to 8% of banks’ assets could be tied up in cash and gilts (British government bonds) that they are forced to hold, reckons Simon Hills of the British Bankers Association, which could have “a huge impact on business models”. That, some ar- ▶▶



▶ gue, is precisely the point of reform.

Much can be done to reduce market stresses without waiting for these reforms. In repo lending—a decades-old practice critical to the smooth functioning of markets—the Federal Reserve may soon toughen collateral requirements and force borrowers to draw up contingency plans in case of a sudden freeze. Banks that clear repos will be expected to monitor the size and quality of big borrowers' positions more closely. The banks could live with that, but they worry about proposals to force secured short-term creditors to take an automatic loss if a bank fails.

Another concern is prime brokerage, banks' financing of trading by hedge funds. When the market unravelling, hedge funds were unable to retrieve collateral that their brokers had "rehypothecated", or used to fund transactions of their own; billions of such unsegregated money is still trapped in Lehman's estate, reducing dozens of its former clients to the status of unsecured general creditors. Brokers suffered in turn as clients pulled whatever funds they could from those they viewed as vulnerable. Temporary bans on short-selling made things even worse, playing havoc with some hedge funds' strategies and leaving them scrambling for cash. Regulators are moving towards imposing limits on rehypothecation.

Early reform could also come to the securities-lending market, in which institu-

tional investors lend shares from their portfolios to short-sellers for a fee. Some lenders—including, notoriously, AIG—found they were unable to repay cash collateral posted by borrowers because they had invested it in instruments that had turned illiquid, such as asset-backed commercial paper. Some have doubled the share of their portfolios that they know they can sell overnight, to as much as 50%.

Regulators might consider asking them to go further. Bond markets, unlike stock markets, revolve around quotes from dealers. This creates a structural impediment to the free flow of liquidity in strained times, argues Ken Froot of Harvard Business School, because when dealers pull in their horns they are unable to function properly as market-makers. He suggests opening up access to trade data and competition to quote prices. Some senior figures at the Fed like the idea, as do money managers, though predictably dealers are resisting.

Twin realities

The other brutal lesson of the crisis concerns the way liquidity can affect solvency. In a world of mark-to-market accounting, a small price movement on a large, illiquid portfolio can quickly turn into crippling paper losses that eat into capital. Highly rated but hard-to-shift debt instruments can finish you off before losses on the underlying loans have even begun to hurt your cash flows. If markets expect fire

sales, potential buyers will hold off for a better price, exacerbating fair-value losses.

In future banks will be more alert to these dangers. "We were looking at the bonds we held, focusing on the credit fundamentals. We lost sight of the capital hit from illiquidity and marking to market that can seriously hurt you in the meantime," says Koos Timmermans, chief risk officer at ING, a large Dutch banking and insurance group. "We now know that you have to treat the accounting reality as economic reality."

Another lesson is the "opportunity value" of staying liquid in good times, says Aaron Brown, a risk manager with AQR, a hedge fund. In an efficient market dollar bills are not left lying around. But in the dislocated markets of late 2008 there were lots of bargains to be had for the small minority of investors with dry powder.

For some, though, bigger liquidity problems may yet lie ahead. Some \$5.1 trillion of bank debt rated by Moody's is due to mature by 2012. This will have to be refinanced at higher rates. The rates could also be pushed up by an erosion of sovereign credit quality, given implicit state guarantees of bank liabilities. And, at some point, banks face a reduction of cut-price liquidity support from central banks—offered in return for often dodgy collateral—which has buoyed their profit margins. Mortgage borrowers on teaser rates are vulnerable to payment shock. So too are their lenders. ■

Fingers in the dike

What regulators should do now

THE Delta Works are a series of dams, sluices and dikes built in the second half of the 20th century to protect the lowest-lying parts of the Netherlands from the sea. They are considered one of the seven wonders of the modern world. The task facing global regulators is to construct the financial equivalent of this protective network, said Jean-Claude Trichet, president of the European Central Bank, in an interview last November.

This will require success in three connected areas: reducing the threat to stability posed by firms deemed too big to fail because their demise could destabilise markets; ensuring that banks have bigger cushions against losses; and improving system-wide, or macroprudential, regula-

tion. The work is under way, but some bits are hobbled by a surfeit of architects, others by a lack of clear plans.

• **Too big to fail.** Dealing with "systemically important" giants is the thorniest problem. Having once been cornered into a choice between costly rescues and gut-wrenching failures, governments are determined to avoid a repeat. When markets swooned, they were obliged to stand behind the big and the highly connected (as well as their creditors), but found themselves ill-equipped. Tim Geithner, America's treasury secretary, said his administration had nothing but "duct tape and string" to deal with American International Group (AIG) when it tottered.

The problem has only worsened dur-

ing the crisis. After a quarter-century of ever-increasing financial concentration, the giants of finance grew even more dominant in 2008-09 thanks to a series of shotgun takeovers of sickly rivals (see chart 5, next page).

Regulators can tackle the issue either by addressing the "too big" part (shrinking or erecting firewalls within giants) or the "to fail" bit (forcing them to hold more capital and making it easier to wind down bust firms). Until recently the focus was on the second of these approaches. But since President Obama's unveiling of two initiatives last month—a tax on the liabilities of big banks and the "Volcker rule", which proposed limits on their size and activities—momentum has been shifting towards ▶▶



▶ some combination of the two.

The Volcker plan—named after Paul Volcker, the former Federal Reserve chairman who proposed it—calls for deposit-takers to be banned from proprietary trading in capital markets and from investing in hedge funds and private equity. The Financial Stability Board (FSB), a Basel-based body that is spearheading the international reform drive, gave it a cautious welcome, stressing that such a move would need to be combined with tougher capital standards and other measures to be effective.

The Volcker rule does not seek a full separation of commercial banking and investment banking. Nor is America pushing to shrink its behemoths dramatically; for most, the plan would merely limit further growth of non-deposit liabilities (there is already a 10% cap on national market share in deposits). Officials remain queasy about dictating size limits. Citigroup’s woes suggest a firm can become too big to manage, but JPMorgan Chase and HSBC are striking counter-examples.

For all the hue and cry about the Volcker plan, America sees it as supplementing earlier proposals, not supplanting them. The most important of these is an improved “resolution” mechanism for failing giants. Standard bankruptcy arrangements do not work well for financial firms: in the time it takes for a typical case to grind through court, the company’s value will have evaporated.

America’s resolution plan would allow

regulators to seize and wind down basket-cases. The challenge will be to convince markets that these measures will not turn into life-support machines. Worse, there is no international agreement on how to handle the failure of border-straddling firms, nor is one close. That was a huge problem with Lehman Brothers, which had nearly 3,000 legal entities in dozens of countries. And the struggle to retrieve \$5.5 billion that a bust Icelandic bank owes creditors in Britain and the Netherlands still continues.

Questions also linger over the treatment of lenders. America’s plan wants it both ways, giving regulators discretion to override private creditors but also to subordinate the taxpayer’s claims. This fuels concerns about handouts to politically fa-

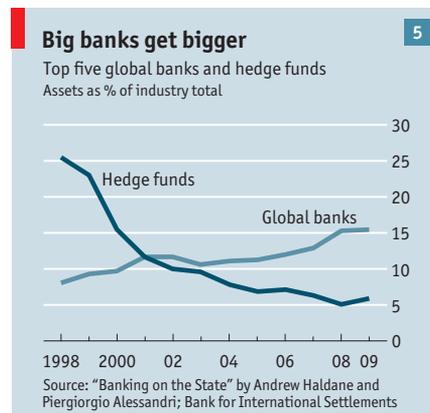
voured groups, as happened in the government-orchestrated bankruptcy of General Motors. Another worrying precedent was the generous treatment of troubled banks’ derivatives counterparties in 2008. All counterparty trading exposures, to the extent that they are uncollateralised, should be at the bottom of the capital stack, not at the top. Regrettably, the opposite happened. This prompted a wave of credit-default-swap buying because these contracts were underwritten by the state. “Today, too big to fail means too many counterparty exposures to fail,” says Peter Fisher of BlackRock, a money manager.

• **Overhauling capital requirements.** In the hope of avoiding having to trigger their resolution regimes in the first place, regulators will force banks to strengthen their capital buffers. A number of countries are considering a punitive capital surcharge for the largest firms. A report from the Bank of England last November suggested various ways of designing this. It could vary by sector, allowing regulators to influence the marginal cost of lending to some of the more exuberant parts of the economy. Or it could reflect the lender’s contribution to systemic risk, based on its size, complexity and the extent of its connections to other financial firms.

How such a penalty would fit with broader capital reforms is unclear. In December the Basel Committee of supervisors and central banks laid out proposed revisions to its global bank-capital regime. These could come into force as early as 2012-13. The new standards, dubbed Basel 3, are less reliant than the last set of reforms on banks’ own risk models. Then the talk was of capital “efficiency”. Now it is all about robustness. With markets already demanding that banks hold more equity, a reversal of a long trend of falling ratios is under way (see chart 6, next page).

Before the crisis banks could get away with common equity—the purest form of capital—of as little as 2% of risk-weighted assets. The new regulatory minimum will not be clear until later this year, but markets now dictate that banks hold four to five times that level. Hybrid instruments—part debt, part equity—will be discouraged since these proved bad at absorbing losses. Regulators are encouraging banks to issue a different type of convertible capital: “contingent” bonds that automatically turn into common shares at times of stress.

In another acknowledgment that relying too heavily on internal models was a mistake, the new rules will be supplemented by a “leverage ratio”. Not weighted ▶▶



▶ to risk, this measure looks appealingly simple these days. One aim is to curb gaming of risk-based requirements: European banks, which unlike American ones were not subject to a leverage ratio, could take their borrowing to dangerous heights because many of their assets were highly rated securities with low risk weightings. One official likens the new approach to placing a net under a trapeze artist.

In an equally big philosophical shift, the new measures will lean against “procyclicality”, or the tendency of rules to exaggerate both the good and the bad. Banks will be required to accumulate extra capital in fat years that can be drawn upon in lean ones. Until now the rules have encouraged higher leverage in good times and much lower in bad times, adding to distress at just the wrong moment. Securities regulators contributed to the problem, frowning on boom-time reserve-building as possible profit-smoothing in disguise. The new proposals will encourage “dynamic” provisioning, which allows banks to squirrel away reserves based on expected losses, not just those already incurred.

Addressing procyclicality will also require tackling issues that straddle capital rules and accounting standards. Critics of fair-value (or “mark-to-market”) accounting, which requires assets to be held at market prices (or an approximation), complain that having to mark down assets to the value they would fetch in illiquid markets is likely to exacerbate downturns. The solution is not to abandon fair value, which investors like because it is less open to manipulation than the alternatives. But there is a case for decoupling capital and accounting rules, says Christian Leuz of the Booth School of Business. This would give bank regulators more discretion to accept alternative valuation methods yet still allow investors to see the actual or estimated market value.

There are lots of potential devils in the details of the proposals. A leverage ratio is pointless without strict monitoring of assets parked off balance-sheets. Contingent capital, meanwhile, could have the opposite effect of that intended if the bank’s trading partners flee as its ratios near the trigger point. There are also worries over increases in capital charges for securitisations, exposure to swap counterparties and the like. These make sense in theory; to treat mortgage-backed securities as almost risk-free was nonsense. But the new rules swing too far the other way, threatening to choke off the recovery of asset-backed markets.

America’s large banks, having repaid their debts to taxpayers, are sure to wage war on higher capital standards. An impact assessment stretching over several months will give them ample opportunity to look for holes—and to lobby. In Europe, where banks were more highly leveraged and thus face a more wrenching adjustment, even some supervisors are queasy.

• Improving macroprudential regulation.

In the meantime regulators can make progress in other areas, such as overhauling day-to-day supervision. In both America and Europe they have stepped up comparisons of pay, lending standards and the like across big firms. They are also introducing peer review. Within the agency that oversees Swiss banks, for instance, the lead supervisors of Credit Suisse and UBS are now expected to scrutinise each other’s work. America’s Securities and Exchange Commission, whose failures included negligible supervision of investment banks and the Madoff scandal, has set up a new risk division packed with heavyweight thinkers such as Henry Hu, Gregg Berman and Richard Bookstaber. Part of their job will be to scan derivatives markets, hedge funds and the like for any emerging threats to stability.

This stems from a recognition that traditional oversight needs to go hand in hand with the macroprudential sort that takes account of the collective behaviour of financial firms, contagion effects and so on. “Finance is full of clever instruments that work as long as the risk is idiosyncratic, but can wreak havoc if it becomes systemic,” says Frederic Mishkin of Columbia University. Moreover, the crisis showed how risk can cross traditional regulatory lines. Pension funds and insurers, previously seen as shock-absorbers, were revealed as potential sources of systemic risk.

However, there is no broad agreement

on how systemic regulation might work, or who should do the regulating. Most economists see the job falling naturally to central banks, because of their closeness to markets and because of the link between capital standards and monetary policy through the price of credit. But there are political obstacles, particularly in America, where a large and vocal contingent in Congress accuses the Fed itself of being a threat to stability, pointing to loose monetary policy as a cause of the housing mania.

International co-ordination is equally tricky. The FSB has singled out 30 of the largest banks and insurers for cross-border scrutiny by “colleges” of supervisors. There is, though, a natural limit to co-operation. It remains to be seen how well national risk regulators work with supranational bodies such as the European Union’s systemic-risk council and the FSB. Private-sector groups want to have their say too: the Market Monitoring Group, a collection of grantees linked to a banking-industry group, is already issuing warnings about fresh bubbles emerging.

Another reason for scepticism is the difficulty of identifying a systemic event. AIG’s liquidity crunch was thought to count as one at the time, hence the offer of an \$85 billion emergency loan from the Fed. But what exactly was the danger? That markets would be brought to their knees by the failure of its derivatives counterparties (who were controversially paid off at par)? Or by trouble at its heavily regulated insurance businesses? More than a year later, no one seems sure.

Pricking bubbles—another mooted role for systemic regulators—is also fraught with danger. Many central bankers consider it unrealistic to make prevention of asset-price bubbles a specific objective of systemic oversight. But thinking at the Fed has been shifting. Under Alan Greenspan its policy had been to stand back, wait for the pop and clean up the mess. But Ben Bernanke, the current chairman, recently backed the idea of intervening to take the air out of bubbles. This could be done mainly through stronger regulation, he suggested, though he did not rule out monetary policy as a back-up option.

Mr Mishkin, a former Fed governor, draws a contrast between credit-boom bubbles and irrational exuberance in stockmarkets, such as the dotcom bubble. The first is more dangerous, and the case for pre-emptive action stronger, he argues, because it comes with a cycle of leveraging against rising asset values.

In retrospect all crashes look inevitable. ▶▶



▶ Even with the most insidious-looking bubbles, though, it is impossible to know at the time how devastating the pop will be. Many thought the economic fallout from the internet crash would be far greater than it turned out. The economic cost of prematurely ending a boom can be high. Even so, the worry is that a systemic regulator would be biased towards intervention, because it would face less criticism for puncturing a non-bubble than for failing to spot a real one.

Alex Pollock of the American Enterprise Institute (AEI), a think-tank, is concerned that the creation of an official systemic regulator would bring false comfort, just as the Fed's founding in 1913 did. According to the then Comptroller of the Currency, it had rendered further crises "mathematically impossible". Mr Pollock would prefer to see the task go to an independent advisory body, manned by economic

heavyweights to provide institutional memory of past crises. For similar reasons, Andrew Lo, director of MIT's Laboratory for Financial Engineering, suggests separating regulation from forensics, as happens in the airline industry. America's National Transportation Safety Board is seen as independent because its job is to investigate crashes, not to set rules after the event. That gives it more moral clout.

Whatever form it takes, systemic policing would face a problem. During booms, governments are loth to take the punch-bowl away, at least until the next election. Nor do they want to be criticised for their own contribution to systemic risk. They may have become even touchier now that they are, as Pimco's Mohamed El-Erian puts it, "market players as well as referees".

A way round this would be to introduce rules requiring the regulator to step in if, say, credit and asset prices are growing at

above-average rates. That would shield it from claims that the next boom is somehow different and should be left to run its course. But it comes at the cost of flexibility.

All of this suggests that although there is a strong case for a more system-wide approach to oversight, it could do more harm than good if poorly crafted. Meanwhile taxpayers will continue to underwrite financial giants; America's reforms in their current shape allow the authorities to pull apart those that pose a "grave threat", but also to bail out their creditors if they consider it necessary.

The danger is that the very existence of a systemic regulator creates an illusion of increasing stability even though it does the opposite by strengthening the implicit guarantee for the biggest banks—a "permanent TARP", as the AEI's Peter Wallison puts it. Too big to fail sometimes seems too hard to solve. ■

Blocking out the sirens' song

Moneymen need saving from themselves

RISK antennae twitch after a crisis. Bankers, regulators and academics, shaken from their complacency, jostle to identify the next tempest. Right now gusts are blowing from several directions. Many countries' fiscal positions are deteriorating fast after costly interventions to shore up financial systems and restore growth. There is talk of demanding collateral even on deals with formerly unimpeachable sovereign entities. Recent terrorist incidents have raised the spectre of external shocks.

Yet at least a fragile sort of optimism has surfaced, born of ultra-cheap money and relief at having avoided a depression. In some markets fresh bubbles may be forming. Stockmarkets have rebounded sharply. America's, though still well off their peaks, are up to 50% overvalued on a historical basis. Banks are once again throwing money at hedge funds and private-equity firms (though with tougher margin requirements). Issuance of structured-loan funds, which a few months back looked dead, is booming. Investment banks' profits, and bonus pools, are back near pre-crisis levels. International regulators have been issuing warnings to chief executives about a return of irrational exuberance. Banks have been ordered to run stress tests involving a sudden jump in interest rates,

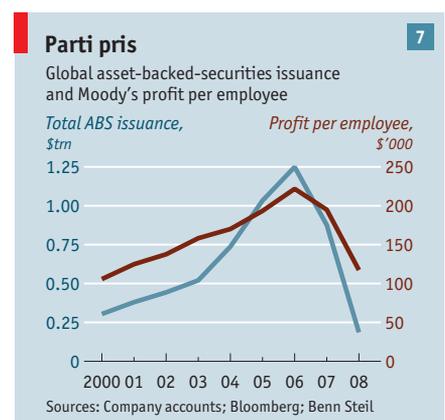
in preparation for central banks' withdrawal of monetary adrenaline.

Many will already be doing this as they try to show that they have learnt their lessons. Like the best chess players, bankers insist that they are now concentrating as hard on avoiding mistakes as on winning. Those that sidestepped the worst mortgage-related landmines now top the industry's new order. Blackrock's Mr Fisher defines risk as "deviation from objective", on the upside as well as the downside. If your models tell you that a security is safer than its returns imply, as with CDOs, that might just suggest hidden risks.

Fancy mathematics will continue to play a role, to be sure. But finance is not physics, and markets have an emotional side. In their struggle with the quants, those who would trust their gut instinct have gained ground.

Learning to tie knots

Governments are taking no chances. Bloomberg counts some 50 bills and other serious proposals for financial reform in America and Europe. Leaders in America's Senate hope to pass new rules by March. But there are limits to what can be expected from regulators and supervisors. Like bankers, they have blind spots. As the



mortgage fiasco showed, they are vulnerable to capture by those they police.

Their job will be made easier if new rules tackle incentives for the private sector to take excessive risk. It is human behaviour, more than financial instruments, that needs changing, says Mr Mauboussin of Legg Mason. Like Odysseus passing the sirens, bankers need to be tied to a mast to stop them from giving in to temptation. Pay structures should be better aligned with the timescale of business strategies that run for a number of years and should not reward "leveraged beta", unremark- ▶▶



able returns juiced with borrowed money. In securitisation, originators will have to disclose more information about loan pools and hold a slice of their products.

Some of the worst abuses in securitisation stemmed from the use of credit ratings. Rating agencies systematically underestimated default risk on vast amounts of debt, resulting in puffed-up prices and a surfeit of issuance. Paid by issuers, they had every incentive to award inflated ratings and keep the market humming: average pay at the agencies rose and fell in tandem with the volume of asset-backed issuance (see chart 7, previous page).

An obvious way to deal with this would be to eliminate the agencies' official "nationally recognised" status, opening the business to unfettered competition. Raters would then have to persuade investors of their competence, rather than relying on a government imprimatur. This, in turn, would force investors themselves to spend more time analysing loans. Oddly, proposed reforms fall far short of this, with no sign of anything tougher on the horizon. CreditSights, a research firm, awarded ratings firms its "Houdini was an Amateur" award for 2009.

Nor, alas, is there much appetite to tackle some of the public policies that contributed to the crisis. The non-recourse status of mortgages in large parts of America, for instance, gives the borrower a highly attractive put option: he can, in effect, sell the house to the lender at any time for the principal outstanding. An even bigger problem is the favourable tax treatment of debt rela-

tive to equity. Phasing this out would discourage the build-up of excessive leverage. But the idea has little political traction.

There are, to be sure, risks to rushing reform. Post-crisis regulation has a long history of unintended consequences, from the pay reforms of the early 1990s (when new limits on the deductibility from corporate tax of executive salaries merely shifted the excesses to bonuses) to key parts of the Sarbanes-Oxley act on corporate governance. Another danger is the pricing of risk by regulation, not markets. The credit-card act passed in America last year leaves providers with a choice between underpricing for some products, which is bad for them, or restricting their

offerings, which is bad for consumers.

Most would agree, however, that markets need both tighter rules and better enforcement. The biggest question mark hangs over the fate of those institutions whose collapse would threaten the system. America's proposal to cap banks' size and ban proprietary trading has fortified those calling for radical measures to tackle the "too big to fail" problem.

The virtues of scepticism

By itself, though, the plan does little to back up Barack Obama's promise to stop such firms from holding the taxpayer hostage. Proprietary trading and investments are a small part of most big banks' activities and played only a minor role in the crisis. Nor does the plan cover brokers, insurers or industrial firms' finance arms, all of which had to be bailed out. To persuade markets that the giants no longer enjoy implicit state guarantees, whether they are banks or not, policymakers will need to present a cocktail of solutions that also include tougher capital and liquidity standards, central clearing of derivatives and credible mechanisms to dismantle firms whose losses in a crisis would overwhelm even a strengthened safety buffer.

Together, intelligent regulatory reforms and a better understanding of the limitations of quantitative risk management can help to reduce the damage inflicted on the financial system when bubbles burst. But they will never eliminate bad lending or excessive exuberance. After every crisis bankers and investors tend to forget that it is their duty to be sceptical, not optimistic. In finance the gods will always find a way to strike back. ■

Offer to readers

Reprints of this special report are available at a price of £3.50 plus postage and packing. A minimum order of five copies is required.

Corporate offer

Customisation options on corporate orders of 100 or more are available. Please contact us to discuss your requirements.

Send all orders to:

The Rights and Syndication Department
26 Red Lion Square
London WC1R 4HQ
Tel +44 (0)20 7576 8148
Fax +44 (0)20 7576 8492
e-mail: rights@economist.com

For more information and to order special reports and reprints online, please visit our website

Economist.com/rights

Future special reports

Managing information February 27th

Germany March 13th

America's economy April 3rd

Management innovation in emerging

markets April 17th

Television May 1st

International banking May 15th

Previous special reports and a list of forthcoming ones can be found online

Economist.com/specialreports