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COVERING YOUR ASSETS: THE MUTATION OF RISK

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- o Economic globalization
- o Shifting assets
- o Pinpointing the risks

MS. DIAN COHEN: My talk has to do with change, and I'll make some references to the markets around the world, how we perceive them, what might have happened and how we can cope with, manage or simply accommodate this kind of change.

Let me start by giving you a little image. Most of you use either typewriters or computers. I don't know how well you type or keystroke, but I will recall for you the top line of the keyboard. It's Q W E R T Y U I O P and that is called Qwerty configuration. The question is, how come? The answer is a hundred years ago, when typewriters were developed, the Qwerty configuration was not the keyboard configuration. But after typewriters had become well accepted, the Scholl's Manufacturing Company started getting a lot of complaints about the fact that there was something wrong with the machine because the keys stuck.

The problem was sent off to the engineering department, and the engineers, who were hunt-and-peck guys, discovered that real typists type fast and in fact typed faster than the machines could accommodate. So the engineering solution was to speed up the machine, the key striking ability. However, in 1880, that was technologically impossible and so the problem was solved by some creative engineers who said that if we can't speed up the machines, let's slow down the operators. So they set about to discover the least efficient keyboard for the English alphabet and the Qwerty configuration was the one.

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One of the things you can see is that the "I" and the "O" are on the right-hand side of the keyboard and are controlled by your ring finger and your little finger, that is, the two fingers of your hand that are connected two inches from the top, which makes them very weak. As it happens, "O" and "I" are the third and sixth most frequently used letters in the English language. All right, so that's where it came from, but now, 100 years later, not only do we have electric and electronic typewriters but we have computers, and I defy you to find a human operator that can work an electronic keyboard faster than the machine allows. So the question now is: Why haven't we changed the keyboard configuration to make it more efficient? It seems to me that the answer is, we're used to doing things in particular ways. We put rules in place when we see problems that need to be solved. In this particular case, the problem was to slow down the operator. The engineers at a manufacturing company discovered how to do that, but even when the problem disappeared, nobody really went back to the reason why.

Now that's just the sort of image that I'd like you to hold because I think that our problem, no matter what business we're in right now, is a problem that involves going back to the reason we do things the way we do. What we can now quite nicely call the good old days were the days before floating exchange rates; the days before cheap, fast global communication facilities; the days before the deregulation of financial institutions; the days in which, when we thought about Canada as a nation or the United States as a nation, we looked at a country in which we were a fairly homogeneous group, in which we subscribed to the same essential value systems, and in which our financial and lifestyle goals were all of a piece. In those days I suppose risk was fairly easy to identify and to manage, and I think that that was true up until about 20 years ago.

During a whole period of time, we set up rules, regulations, institutions and ways of doing things that conformed to the kind of society in which we had grown up. However, then we stopped doing business the way we always had. For those of us who have been in the work force for 20 or more years, we're really the first generation of business people who have had to cope with so much change so fast; this is not to say that there haven't been enormous changes all through history. However, what we're dealing with is change on a different level. Also, I suppose that you're the front-line group of people that has to juggle a lot of different things because your business is so carefully focused on risk, which is so directly related to change.

First of all, you have to work effectively. You're working for yourselves, but also for a company and the bottom line is, make money. In addition to that, you have to understand and identify new risk. You have to recognize how traditional risks might change. You have to manage the risk and ultimately, I would hope, we simply have to find ways of accommodating risk.

So, I want to talk a little bit today about how these changes have come about, why they've come about, and what, essentially, we may be able to do about them. Eliminating these changes is one of the options, I think, that we don't have. I'm going to start with a very short history.

Until the sixties or the seventies, the economic environment, the background environment within which we all operate, was a fairly benign one. Inflation was relatively stable and had been for virtually a generation, maybe even more. Economic growth was on a gently upward sloping trend. Inflation wasn't a problem, and if inflation wasn't a problem, the anticipation of inflation wasn't a problem. Interest rates were stable. Competition was normal, in the sense that the pace of technological and financial innovation was a measured pace. We could keep up with it, with a little bit of excitement and long periods of just nice, easy days. However, 20 years ago, and I won't get into any of the economics of it, we all saw that we were going to have to accommodate not only accelerating inflation, but also the anticipation of inflation, interest rate volatility that we had not had to experience before, and competition fostered by the exponential growth of technological and financial innovation.

The process of change always increases your exposure to risk and not just to traditional risks. For example, will you, your client, or your financial supplier get paid back principal and interest if you lend out money? However, we all were exposed to whole new kinds of risk. I think at this point we have to make distinctions between traditional risk, pre-1970s, which was acceptable because our world was a lot smaller. We have always dealt in some ways globally, but pre-1970, the biggest financial institutions, the banks, mostly lent money for business inventory, for current operating expenses. It was self-liquidating and the risk -- namely, the risk of default, that credit risk with which we're all familiar -- was handled well. It was handled by being very selective about the activities in which one engaged.

After the 1970s, the world was not so narrowly focused on doing business at home, any domestic economy being the center of how you do business. To use the banks as the example, because banks are supposedly the biggest financial institution, businesses after the 1970s started using bank loans as substitutes for equity, and their debt management problems increased as the interest rate risk increased and as the economy became destabilized. The background environment changed. The national focus for any kind of economic policy or decision making moved international. The size of loans in the financial community grew, first because oil and gas exploration was important and expensive, and then because of real estate investment. Later on, as an outgrowth of getting used to lending out bigger and bigger amounts of money, decision making moved over to things like leveraged buyouts.

Project loans were a new development. The idea that debt could be serviced from expected cash flow, which emerged by the early 1980s, ceased to materialize in many instances. So then we got into not just simple, traditional kinds of risk, but into risks that we never before had to consider seriously. They are the following.

1. Country risk -- We were going outside of the area that we knew well, where it was cheap and easy to get credit information. We were moving farther and farther afield, and we had to worry about the political and social stability of other countries. We had to worry about nationalization, expropriation, government repudiation of international debt, and foreign exchange controls and the fact that those experiences were not easily managed. We know that for the first 5, 6, or 7 years, certainly throughout all of the 1980s, the loan loss experiences of financial institutions have certainly exceeded the loan loss provision.

2. Interest rate risk -- Yield curves, as far as we all recognize them, always had a stable and positively sloped curve. It wasn't a problem but because legislation changed, and certainly in Canada the ceiling on interest rates was removed because of fundamental changes to the economy, there was a reversal of the interest rate yield curve.

New kinds of risk management had to be developed just to deal with these new kinds of risk. We developed new financial instruments, such as interest rate futures and swaps and put call options. Some of these had the effect of reducing risk, and others, when handled in an incorrect way, limited our profit potential and made us more vulnerable to interest rate instability. We could go on with all of the new things that we had to cope with, such as funding risk and whether an institution can get and keep the amount of deposits it needs to finance its assets and historically the answer has always been yes. Now it's uncertain whether that's true, and increasingly, financial institutions have had to go farther and farther afield in terms of triple A quality to esure that they do have funding risk. We've developed a lot of funny things that have had to be handled because of these kinds of changes, things like the contagion effect. In Canada, I suppose one good example of the contagion effect might have been the demise of the Northland Bank, which had been contaminated essentially by the failure of two other western institutions. Northland didn't fail necessarily because by itself it lost its deposits. With the commitments that most financial institutions now have, whether letters of credit, financial futures, loan guarantees or whatever, other kinds of financial instruments to deal with risk have been invented. Among them are miffs and ruffs and sniffs, and when I think about how the acronyms sound, what I think I'm doing is reading a Captain Marvel comic book. The point is that, in developing new financial instruments to handle risk, we are not yet sure where the ultimate risk lies in many of these instruments because all of this has happened within such a short period. When we look at the situation in the stock market over the last couple of days, one of the things we have to recognize is that the only benchmark we still have is 1929, despite the following:

1. There has been ample warning that there are discontinuities in the system.

2. The symbol part of the economy -- that is, the money part of the economy -- has become unhooked from, or at least partially unhooked from, the real part of the economy where we trade in goods.

3. We've seen the risk of third world debt and American trade deficit balanced on the other side by Canadian, West German and Japanese trade surplus, where we've seen the exchange rate instability that we have had over the last several years.

Our perception of the marketplace is that 1929 is something that happened a long time ago and only the most spectacular, perhaps charlatan, would suggest that it could happen again.

It is unclear at the moment whether a depression has happened again, and all commentary right now is a calming commentary saying that things look better than they did yesterday, at least the Dow Jones ended up 100 points. Again, I want you to keep in your mind the perception. Can you imagine if I said to you two weeks ago the Dow Jones went up by a hundred points? What would be our reaction? "That's insane!" "It's terrific!" Now the Dow goes up by 100 points and we say, "Well, you know, gosh, that's pretty good," but it was down by 500 in a day and it must have been down more than a thousand points in the last week or so. Perception is also very important.

Even though the commentary today is, "Well, we had the stroke and now we're in intensive care and things are really looking good," the fact is that we are again making these kind of statements on the basis of single numbers and our ingrained belief that if the market starts going down again, we're going to get 1929 again.

In other words, we're making links that are not necessarily there because the whole structure of the economy has changed so much. Even something as simple as saying that when you look at the economy that we all started out working in, it was an economy based on just that the simple family level -- that is, an economy based on a family unit with two parents, one of each sex, two children, a mother who stayed home, and a father who went out to work. Father could expect to work for 40 years, probably at the same job, certainly not more than two different jobs, get a pension, come home, retire and die within a fairly short period of time after retirement. That picture fits half the population. I'm not even sure that it's half at this point, but certainly even the idea of what the family structure is like has changed enormously.

I've been in the work force for about 25 years. One of the things we think about when we think about our society is big business creating jobs and wealth. That's its function. That's what brings big business to any bargaining table, whether it's a bargaining table with labor or a bargaining table with government. Big business does not bring jobs to the table anymore. I am not disputing whether it still brings wealth. The issue now is that rapid technological change has meant that we can now produce more and more goods, cheaper, with fewer people. And again, in the sort of simplification and popularization and indeed even vulgarization of what in fact are fundamental movements in our society, we develop a lot of myths. And one of those myths is that big business is still where it's at. It's not clear.

It's not clear, with the down-sizing of big business and the movement toward appropriate size niche marketing, whether small business, "work-for-yourself" is permanent. We just don't know. What we do know is that change is something that we've had to deal with for at least 20 years where it's been visible, and maybe for a lot of us, it's only been visible in the last five or ten. In regard to the terms of the marketplace, one of the things you do is model. One of the things that I used to do is model. One problem with modeling is that models are based on what we already know, and certainly in terms of the econometric models, all we have to go on is history. This is the way it used to be, given the society, the demography, the political, the legislation, and the institutional framework in which you can put just about everything -- education system, the tax system and so on.

Into that mix we can extrapolate to a different kind of world, sometimes straight line, sometimes curved. Basically we're using a model we understand. Our problem is that the model is changing very fast and that means that the techniques that we use to measure and to forecast have to change. Now, undoubtedly you've seen tremendous change in the way you do your work. In terms of what I tend to report on and what I've talked to you about here using examples from the general financial community, lots of different instruments and measurements have been invented, but many of them are still the same as we have always used. Now, we're going to move out of measurement systems, and I'm going to give you another image because there's really only one message here. That is the message that we are dealing with change in some way, and I'm not quite sure how.

Take something as simple as the education system, one kind of institution that's been put in place to facilitate the workings of a society as it has been structured and as it's evolved. The education system began as people moved to the city from the farm at the beginning of the industrial revolution. What was its function? Well, its function was essentially to provide a work force that was competent to go into the new industrial economy. So what do we do in our educational system? Basically, we teach people to obey. We have 2,500 or 3,000 tests, quizzes, exams before we finish school, and it impresses us when we get high marks.

We have a system, an educational system, that provides for people to move in an assembly line process. You sit in a spot, you do your job. If you do it properly, you're commended; if you don't do it properly, you're out, you're not asked to think at all. But we don't have an industrial society anymore; there aren't people on assembly lines anymore. Yet we haven't got around to thinking about what we should be doing in terms of changing those rules and regulations or dealing with a society where we cannot yet see the end of changing background environment. This presents the problem of having a society that's no longer homogeneous, that's become rich enough to have different value systems, different goals, different priorities, and agendas. We again have to change the rules to accommodate them all. Earlier, we were talking about the fact that probably none of your models included one that had losing as a range. I guess 20% is a good enough round number. Losing 20% of the asset base in one day. That's something that hasn't happened before. The question now is, what kind of a model do you make or is modeling appropriate at all?

In the scheme of things today, we're not necessarily looking at a blip, but at a situation where there's going to be a different world. One of the first things we all have to understand is that even if this market goes back to some kind of stability, the confidence of the world has been shaken and the idea that one can trust what has been done before or said before is now suspect. In terms of watching the market now, obviously what we have to do is look at the things that we measure. I started to say that we are all at fault in regard to using single measurements like the Dow or like what's happening in the index that's used in Tokyo. What one now has to watch is the continued volume of trade, what happens on the AMEX, what happens on the over-the-counter and NASDAQ market.

Those markets are still in total disarray, and what may now be buying opportunities for institutional investors may very well be selling opportunities for all of the people who are simply stunned by movements on Friday, Monday and

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Tuesday. I want to end this piece in a way that suggests to you that because change has accelerated so enormously in the past 20 years, we've all had to begin by coping with change and risk, and I'm using these words interchange-ably, to manage change or risk. Now the question is: Is it time to move on to simply accommodate risk?

In other words, should we be moving out of the modeling and measuring that we're used to, which is based on historical data that we understand but doesn't quite fit anymore, to simply broadening our horizons so that we accommodate the one certainty in our lives, which is uncertainty? As national boundaries, economic and otherwise, continue to break down, other kinds of risk will evolve and we won't even know what it is until it's upon us.

I suppose there are a couple of different scenarios for the future. One of them, and I think a fairly logical outcome, is that we will develop a single world market. After all, a lot of the risk that we're not having to manage has to do with multi-currencies and national regulatory bodies. So if we could develop a single-world financial market with one currency and a supranational monetary authority and maybe one monetary policy, then interest rate risk and foreign exchange risk would automatically disappear. They would just be eliminated. The other option that we have, because we don't have an option of staying still, concerns decreasing our exposure to risk and rebuilding the barricades against capital flows. Doing that will be much harder than getting the genie back into the bottle, now that the rules and regulations have already broken down. So let me leave you with yet another image for accommodating risk and change.

Somewhere back in the eons of history, a plague came to a small European country, and the symptoms of the plague were that people sickened rapidly and fell into a death-like coma, and it was really horrid to figure out whether people were in fact dead or whether they were just in a coma from which very, very few ever recovered. It happened one day that somebody was buried alive, and this was very upsetting to the whole community. The community leaders got together and said, "We just don't want this to happen again, so what are our options?" One option that was developed was that food be put into the casket and that in fact an air hole be drilled down from the surface, so that if indeed it happened that someone was buried alive and they recovered, they would in fact be able to survive.

Another group, maybe the corporate treasurers who were under fiscal restraint, decided that that was too expensive, and they suggested that it would be more efficient simply to put a stake in the lid of the coffin, a 12-inch stake just somewhere in the vicinity of the heart, so that when the coffin lid was closed, there would be no possibility that someone might be buried alive. Now, really all I've suggested to you concerns changing perspectives in order to find the second option.

The first group of people dealt with the question of reducing the risk of burying someone alive. The second group of people dealt with the question of ensuring that everybody who was buried was dead. On that, I will thank you for your attention and leave you on the note that you should not take the first right answer that you learned more than 20 years ago.