Risk Management: Buyer Beware!

by Dennis Barry

"Beware of geeks bearing formulas."

—*Warren Buffet, 2008*.

"If it looks like a loan, acts like a loan, and performs (at least in the beginning) like a loan, it's probably a loan."

—*Paraphrased from a truism about waterfowl, origin unknown*.

There are certain aspects of the world of finance, and more particularly of the world of loans, that seem obvious if only to the non-professional. For example, any time you lend money, to anyone, there is some risk that you might not get it back. With the possible exception of full faith and credit debts of the United States, every loan carries some risk with it regardless of the borrower, and this risk varies depending on the creditworthiness of the person or institution that is supposed to repay the debt. Bearing that risk requires some sort of capital, both as a legal requirement and as evidence of good sense in lending, but recently we seem to have forgotten the basic relationship between a loan and the capital associated with it. So, let's review how it should work:

If Institution A makes a loan, a certain amount of capital is required to support that loan. The amount of capital should be related to the likelihood of repayment of the loan.

If Institution A offloads that loan to Institution B, regardless of how that offload is structured, the same amount of capital is still required to support that loan, and possibly more. The provider of the capital may change, but the amount cannot be less than it was before the loan was transferred.

If Institution B breaks the loan up into little pieces and packages the pieces with pieces of other loans it has acquired and then sells the package to Institution C, the same amount of capital is still required to support the original loan, and possibly more. Again, the capital provider(s) may change, but the overall amount cannot be less.

If Institution C, and all the other institutions that end up with pieces of the loan originated by Institution A repackage all or part of their respective shares, recharacterize the resulting whatcha-ma-call-its, rename those same whatcha-ma-call-its, and resell them to Institution D, the same amount of capital is still required to support that loan, and possibly more.

You get the idea. No matter how the original loan is sliced, diced, packaged, wrapped and maketed by anybody, the same amount of capital is still required to support that loan, and possibly more. The provider(s) of the necessary capital may be different, but the total amount of capital associated with the original loan cannot be less. And if, somewhere in the chain, one of the parties **guarantees** the performance of all or part of the original loan, no matter how the guarantee is structured, the same amount of capital, and probably more, is required to support the loan.

Somewhere in the credit default swap assembly line, that little piece of fact was lost, ignored or redefined out of existence. The same is true for the mortgage-backed securities issued by Freddie Mac and Fannie Mae, although in that case perhaps the existence of such a strong connection to the federal government made security seem stronger than it really was. But, at the end of the day, a mortgage-backed security (being backed by mortgages), is only as good as the underlying assets—garbage in, garbage out, as the saying goes. The same can be said for securitized credit card loans, and so on. And if a counterparty that has guaranteed performance of the original loan at the end of this chain turns out to not have the wherewithal to make its promise come true, the whole chain comes apart, as we've seen.

The lesson of the current debacle is, or certainly ought to be, that the risk inherent in a financial transaction cannot be made to go away by the mere act of repackaging that transaction and renaming it. For the front end of the process to write rotten loans and then have the risk disappear via the vehicle of someone renaming those loans leads to ultimate financial ruin, as evidenced by what's going on

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now. The sow's ear is still a sow's ear, despite all attempts to make it otherwise. If the current regulatory structure, coming from whatever regulator(s), allowed some or all of the capital needed to support a loan to disappear just because the original loan has been repackaged and renamed, that is a major regulatory failure. And if current audit procedures and debt-rating processes allowed the same thing, those are failures as well.

Whatever regulation comes out of this mess should focus on this fact. In the scenario above, Institution A should not be able to release the capital attached to that loan until it has regulatory proof that Institution B has that amount of capital set up for the loan, or more. Similarly for Institution C and Institution D and so on all the way through the chain. Moreover, if the repackaging of the original loan, in whatever form, adds risk to the overall chain, then the appropriate level of additional capital must be held as well.

This sort of regulatory approach already exists in the world of insurance. A direct writer may cede reinsurance but may not release either reserves or capital unless the reinsurer puts both on its own books and **is allowed by regulators to do so**. If retrocessions are involved, each ceding company must retain whatever portion of the necessary reserves and capital unless the accepting company agrees to take on the risk, **and is legally recognized as being permitted to do so**. If a reinsurer is not legally permitted to accept a particular piece of reinsurance, other means of security must be provided before the ceding company can be done with that portion of the risk. This approach makes sense and works well, but it doesn't make the system foolproof. There are lots of horror stories involving complex reinsurance pools that failed. Risks get pooled and offloaded in all kinds of packages, and sometimes the accepting company isn't sure of what's going on upstream. However, that's a management failure, not a regulatory failure. It's almost impossible to regulate stupidity (aka irrational exuberance) without becoming a surrogate, hands-on manager for all regulated institutions. That's not a practical regulatory solution for anyone.

Regulation that requires conservation of capital, and reserves if appropriate, for financial transactions would be a strong first step in preventing a recurrence of what's going on today. No restructuring or recharacterization of a loan, or other transaction, downstream can eliminate the need for the capital originally required. If there are jurisdictional issues, they need to be sorted out as well, but adequate capital for financial transactions must be the bottom line.

A second step might be to require the institutions involved to limit incentive compensation to time frames of at least three years. While any arbitrary time frame would not be risk-free, it is clear that one-year incentives can reward behavior that, over time, might turn out to be unhealthy for all of the institution's constituents. It would be better to remove temptation, to the extent possible, without simultaneously removing all incentive for a company to grow profitably. Three years seems like a suitable period.

A third step, admittedly hard to precisely define beforehand, should bring the auditors and rating agencies into the equation as well. It is hard to imagine that AIG deserved a clean audit opinion as of December 2007, and was broke by the end of September 2008. The same can be said for Merrill Lynch, and many, many others. And the same is true for many securities that were highly rated when they were in fact rotten. No doubt the courts will determine culpability in what has happened recently, but for the future responsibility ought to be clear, unambiguous and enforceable.

We began this essay with a couple of quotes that seemed appropriate to the topic. Let's end with one that summarizes the current situation, succinctly and accurately:

> "We have met the enemy and he is us."
> —*Pogo the Possum (Walt Kelly), 1970.*

Let's hope we can do better in the future, for all our sakes.

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