Your Mother Should Know

by David Ingram

Something as massive as the current financial crisis is much too large to have one or two or even three simple drivers. Below is a discussion of three drivers that are often not at the top of lists about the origins of the crisis. And in all three cases, my mother would have cautioned against those mistakes.

When I was 16, I had some fine arguments with my mother about the girls that I was dating. My mother did not want me dating any girls that she did not want me to marry. That was absolutely silly, I argued. I was years and years away from getting married. That was a concern for another time. My mother knew that in those days, "shotgun marriages" were common, a sudden unexpected change that triggered a long-term commitment. Even without getting a shotgun involved, five years later I got married to a girl that I started dating when I was 16.

Well, there are two different approaches to risk that firms in the risk-taking business use. One approach is to assume that they can and will always be able to trade away risks at will. The other approach is to assume that any risks will be held by the firm to maturity. If the risk managers of the firms with the risk-trading approach would have listened to their mothers, they would have treated those traded risks as if they might one day hold those risks until maturity. In most cases, the risk traders can easily offload their risks at will. Using that approach, they can exploit little bits of risk insight to trade ahead of market drops. But when the news reveals a sudden unexpected adverse turn, the trading away option often disappears. In fact, using the trading option will often result in locking in more severe losses than what might eventually occur. And in the most extreme situations, trading just freezes up and there is not even the option to get out with an excessive loss.

So the conclusion here is that, at some level, every entity that handles risks should be assessing what would happen if they ended up owning the risk that they thought they would only have temporarily. This would have a number of consequences. First of all, it could well stop the idea of high speed trading of very, very complex risks. If these risks are too complex to evaluate fully during the intended holding period, then perhaps it would be better for all if the trading just did not happen so very quickly. In the case of the recent subprime-related issues, banks often had very different risk analysis requirements for trading books of risks vs. their banking book of risks. The banking (credit mostly) risks required intense due diligence or underwriting. The trading book only had to be run through models, where the assignment of assumptions was not required to be based upon internal analysis.

My mother would often caution me against some activity by saying, "What if everyone did that?" She did not allow any actions that were not sustainable as a general course for everyone.

Well, an implicit assumption in the way that many practitioners use financial models is that their planned activity is marginal to the market. If you ask the manager of a large mutual fund about that assumption, they will generally laugh out loud. They are well aware that their trades must be made carefully to avoid moving the market price. Often they will build up a position over a period of time based upon the normal flow of trading in a security. That is a very micro-example of non-marginality. What happened with the subprime mortgage market was a drastic shift in activity that was clearly not marginal. When the volume of subprime mortgages rose tenfold, there were two major changes that occurred. First, the subprime mortgages were no longer going to a marginally more creditworthy subset of the folks who would technically fit into the subprime class; they were going to anyone in that class. Any prior experience factors that were observed of the highly select subprime folks would not apply to the average subprime folks. So what was true on the margin is not true in general.

The second marginal issue is the change in the real estate market that was driven by the non-marginal amount

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of new subprime buyers who came into the market. On the way up, this expansion in the number of folks who could buy houses helped to drive the late stages of the price run-up because of that increased demand. That increase in price fed into the confidence of the market participants who were feeding money into the market.

Risk managers should always be aware that marginal analysis can produce incorrect results. They should follow my mother's caution "What if everybody did that?" and look into their statistics more carefully.

When my friends and I gathered in my backyard to play various games, my mother always kept her ears open. She was always pointing out that I was often trying to impose rules or rulings that would in current business terms be called self-dealing.

There were signs that something was dangerously wrong in the U.S. housing market at least six months prior to the August 2007 market freeze. Back in February 2007, HSBC reported large additions to mortgage loan loss reserves for its U.S. business. The first public reports of a stoppage in the run-up of real estate prices came out in the spring of 2007. But several of the firms that experienced the largest losses did not stop their activity until the day that the market froze. How could they be so blind?

Some of this was driven by the folks who themselves were employed full-time doing that business. To them, this activity was the sole source of their income. They had to keep dancing. They had to hold the opinion that the bad news was a temporary blip and that things would soon turn around. In fact they had very strong incentives to portray the situation that way and to cast doubt on anyone who claimed otherwise. That would make the decision to pull back on the subprime-related activity a battle between the financial/risk area and a major revenue source. The extreme version of this issue is what is being reported in the press about the accounting for the financial products unit at AIG, where the business unit head excluded a key audit person from their discussions of how they would account for their CDS business—where decisions were made that ultimately led to a finding of material weakness by the independent auditor.

Risk takers need to have a reliable source of independent information about the risks of their businesses that is outside of a political fray. It happens again and again that business managers portray the risk assessment as a political decision. But a simple look at incentives would reveal that only one player—the business managers themselves—has the incentive to push a particular point of view. A simple grid can be established that looks at four possibilities: 1) that the negative risk assessment is true and the firm acts to reduce potential losses; 2) that the risk assessment is false and the firm reduces activity to reduce losses; 3) that the assessment is false and the firm acts; or 4) that the assessment is false and the firm does not act. Under most compensation programs, the business manager will be incented to continue business regardless of the risk. They are incented AGAINST risk management. Usually, the risk manager incentives do not change materially under any of the four scenarios. Top management needs to be aware of this incentive mismatch when listening to the arguments.

Often you hear the phrase "it's not the money it's the principle," which almost always indicates that it is the money. My mother would have known.

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