

AMERICAN BANKER

On Focus and In Depth

Turmoil in Financial and Credit Markets

The Crisis So Far: A Market Restructured

Risk management returns

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Fifth in a series

Whether the government or investors force it, change is coming to the country's credit markets.

A key element of that change will be reuniting asset originators with some responsibility for their products. Their dissociation emphasized volume rather than quality, put fees in front of interest and principal repayment, and further commoditized lending.

The economics of the originate-and-distribute model were — and are — seductive.

"The complexity of modern finance — involving originators, securitizers, and investors — is based on compelling mathematics that shows how you can slice and dice the risk up into little pieces and allow everyone a piece according to their own risk preference," said Richard Brown, the chief economist of the Federal Deposit Insurance Corp. "On paper, it's a beautiful system, but now we recognize that there were some faulty incentives in the system. Not everyone had skin in the game in terms of the final outcome."

Getting the incentives right will take some time. In the meantime, the prolonged constriction of the capital markets presents an opportunity for traditional lenders with balance-sheet capacity and the courage to use it.

"Banks are still able to underwrite, evaluate, and fund some of the credits that the markets are

nervous about," Mr. Brown said. "Earlier this decade the pricing of bank loans was very thin, because of the competition from market-based lenders. I think we'll see improved pricing for the banks, and the risk-return ratio will be more favorable for some of these credits."

Longer term, however, the securitization spigot will open.

"Will we go back to the days of all assets on the balance sheet? I don't think so, but we're not going back to the days where everything could be sliced and securitized," said Toos Daruvala, who heads McKinsey & Co.'s banking and securities practice for North America. "Somewhere in the broad gray zone, we are going to find some balance, and institutions should be thinking about that now."

Structured investment vehicles are likely done. The future of collateralized debt obligations is a little more uncertain; the taint is so strong that the name is surely dead, but the basic concept may still have a place in the capital markets.

Though burned investors are tempted to think otherwise, the failure of the CDOs may be more about incompetence than immorality. Packagers generally priced the products with models that failed utterly. Investors will require the banks — and the rating agencies — to come up with better models before they commit their money again to those types of structures, whatever their name.

The structures are likely to include stronger collateralization of the senior tranches, and disclosure that allows investors to monitor a structure's assets theoretically would restore confidence. The initial crisis, though precipitated by delinquencies and traditional credit problems, spread because investors could not draw borders around their exposure.

Investors "found disclosure is absolutely insufficient to allow them to measure the risk, and even if they did have the disclosure, the techniques that have been used so far have been proven to be dramatically wrong, even on simple structures," said Donald van Deventer, the chief executive of the consulting firm Kamakura & Co. Investors have "zero confidence in calculations on more complicated collateral like asset-backed securities underlying CDOs."

The limitations of the pricing models — generally known as copula-based models — are well established, but there is no clear alternative at this point. That presents another opportunity for banks.

"Major commercial banks could improve best practices in risk management and modeling on pricing in a way that provides more leadership, perhaps providing a proper platform for CDO pricing," said Darrell Duffie, a finance professor at Stanford University's Graduate School of Business.

Copula-based modeling became standard because it was easy to use, but now "we've realized that it is no good," Prof. Duffie said. "There is no replacement standard, and if there is one, it will be more complicated, and somebody has to take the lead on that."

Some of the other lessons learned are for investors, and they are pretty basic.

"If somebody sells you a package without letting you see inside of it, then you are probably getting ripped off," Mr. van Deventer said. "That is true if it is a department store's pre-Christmas sale or a structured product that you don't know how to value."

Some of the lessons are for policymakers and are quite broad.

"We need a paradigm shift in the way we think about the economy," said former Comptroller of the Currency Eugene Ludwig, now the CEO of Promontory Financial Group. "We think about this as a consumer economy, and that all one has to do in life to make things better is go to the mall. That's not reality. It's what Spain did in the 15th century when it got gold from the New World. It spent it all and ultimately built the rest of Europe's manufacturing sector."

And some of the lessons, of course, are for bankers. Cycles may repeat themselves, but the post-cycle landscape is never exactly the same as what came before the cycle. The sooner bankers can stop thinking about today's credit crisis, the better prepared they will be for tomorrow's business model.

"We've had this great run over the last several years around credit and structured products, and that run has come to a halt. That won't disappear completely, but how it comes back, what shape it comes back in, in what period of time, in what asset classes, are all important business-model questions that affect both the wholesale and retail sides of the bank," Mr. Daruvala said. "Right now, frankly, most institutions have not turned their minds to this, because they are appropriately engaged in righting the ship."

The most assertive steps bankers have taken in righting the ship have focused on risk management. It has taken only about \$240 billion of writedowns — and additional billions in spiraling credit provisions — for bankers to become born-again risk zealots. Chief risk officers now sit on the executive committee of every large banking company in the country, and many investment banks. Holding the red flag, and maybe even throwing it, has become cool.

"I am encouraged at the rededication of some very senior people to high-quality risk management, and it's been a long time since we've seen that," Mr. van Deventer said. "The late '70s and early '80s was a boom time for risk management, because rates got out of hand, and I think this is a repeat of that intensity."

At many banking companies, the risk function itself has been reorganized and now sits both

within and on top of the business lines. Organizational consultants are hammering home that best practices in risk management require full commitment from the chief executive and the board, and empowering risk officers to stand up to rainmakers. The goal, the consultants say, is for the business lines to assume risk rather than pawn it off as a cost associated with the control function.

At some institutions "there is simply a much better partnership between lines of business and risk organizations, and then there are other institutions where the culture is one of risk management being two steps behind the line of business, which is running forward to capture the next opportunity," Mr. Daruvala said. "When you have that model, watch out."

Outsiders can only make informed guesses about the quality of risk management at the large banking companies and investment banks, but it's easy to conclude that most had laggard risk functions. Those firms that did sidestep problems are being hailed as having the structure and culture that others should emulate.

Firms that have avoided problems are so hard to find that not getting crushed by the recent crunch has become the litmus test of risk management. With so few success stories, driving changes in risk management into the corporate culture is perhaps the most pressing question organizational behavioralists are tackling.

They are facing two huge problems. One is that Wall Street has long looked to outsize financial incentives — with minimized risk inputs — to attract and retain talent. A temporary realignment of risk priorities may be no match for that pervasive, calcified culture.

An even bigger problem sits in the hippocampus of the collective societal brain. Cycles are cycles for a reason. We learn lessons — plenty of them — but we forget them. The new era of risk management may draw to a close as soon as the next up cycle begins.

"We've got highly motivated CEOs who have seen their predecessors get fired for not paying attention to risk," Mr. van Deventer said. "Maybe two or three years from now the attention to risk management will fade again, but until then it is on the top of everyone's list of things to think about."

Part Six: There is some [good news for bankers](#), and some of it comes from a much-lamented accounting model that has forced them into a reckoning with value.

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