VIEWPOINTS

An Experiment in Risk

BY PHILIP MAYMIN
and ZAKHAR G. MAYMIN

Whatever new regulation on risk is ultimately imposed on financial entities, is a moot point. With the exception of two unlikely approaches, the result will always be increased risk.

Even worse, the result will be increased systemic risk, meaning we will continue to face a series of crises.

There is some randomness as to when those crises will occur, but they are virtually guaranteed to continue.

We have recently found this in our research, and the basic idea is this: for any algorithm enforced by regulators on banks to manage risk, a few securities will, purely by random chance, appear to have much lower risk than they truly do.

For example, current risk standards look at historical movements to proxy for risk.

But it turns out that there will always be some securities that, purely randomly, exhibited much lower risk in the past than they truly have.

We demonstrate this mathematically and also empirically: the 1% of stocks with the lowest volatility over any five-year period experienced on average an 85% higher volatility over the next five-year period.

Banks will naturally gravitate toward establishing positions in these seemingly low-risk securities because they are able to hold less risk capital on them than on other positions.

Banks do not face significant market discipline for taking on too much risk, because the government guarantees deposits.

Therefore, instead of different banks simply holding different well-capitalized risky positions, all banks will tend to hold combinations of those few and rare securities that falsely appear to have less risk.

If banks and their customers had to bear this risk, they would avoid holding securities with such low risk reserves, or face the prospect of depositors moving their business elsewhere.

But depositors in America don't care at all about the risk of the financial institution they entrust with their money. The overwhelming No. 1 concern is a convenient location.

So, as all banks concentrate as much as they are allowed to into these few securities that randomly displayed falsely lower risk, the systemic risk of another financial crisis increases, because when any one of these particular securities later experience a typical downward movement, banks will find themselves undercapitalized based on the regulations, and will be forced to liquidate those and other positions quickly to raise enough cash to replenish their reserves.

And so a modest move in a few critical securities would suddenly result in the collapse of the entire financial system.

The call in regulatory circles seems to be for more global coordination, just like a century ago the belief seemed to be that we needed federal regulation of deposit-taking institutions. Unfortunately, this would make things even worse: systemic risk would result in a global collapse, with nowhere to run.

Can anything be done to prevent this? Perhaps throwing more regulations at the problem?

The answer, perhaps surprisingly, is no.

Any objective regulation will always result in increased risk, and increased systemic risk of collapse.

There are two exceptions to the rule, both of which allow subjective regulations rather than objective ones.

One exception is to eliminate the pretense of private banks and fully nationalize all deposit-taking institutions.

Then the banking regulator can subjectively decide the risk required for each position at each bank.

Of course, we then are left with the risk of the regulator making unwise decisions with no market mechanism to limit his choices.

The other alternative is to eliminate deposit insurance, and with it, central banking and all of the regulations on financial entities.

Only when banks are responsible to depositors and face market pressure to avoid excessive risk will they allocate what they truly believe to be adequate risk capital to their positions, rather than establish risky positions that appear less risky according to regulatory criteria.

Of course, both of these are dramatic changes, and it is quite unlikely that either would be proposed, much less pass.

So does this mean there is no hope for reducing our risk of future collapse?

There is a possible incremental solution: experiment.

Nationalize a few banks, perhaps starting with the weak ones that the government has been rapidly taking over recently anyway. Offer them as a "public option" for depositors. Appoint regulators to try to manage their risk as best they can.

These banks should be shut down if they fail, but under no circumstances are these banks to be bailed out, in order to keep the experiment valid.

Also create a privatized zone of banks that are free of the FDIC, the Federal Reserve and all other risk regulations, where depositors' money is not insured, but the bank's decisions are not restricted either.

It will be up to banks to provide information that the market demands in order to attract investors or depositors.

Let's have an honest horse race between the fully nationalized, the objectively regulated and the free, and see which system works better.

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FEEDBACK

Mark-to-Market Plan Counterproductive

Re "FASB Plan Could Have a Seismic Impact" [page 1, May 27]:

Where were the accountants when the balance sheets of **AIG**, **Bear Stearns**, **Lehman Brothers**, **Citigroup**, **RBS**, **Barclays**, **Fannie Mae** and **Freddie Mac** were being loaded down with toxic instruments?

These catastrophic accounting failures should by themselves be sufficient justification to turn the accounting profession out onto the streets.

Now they propose new accounting standards that will mark the end of community banking as we know it, bringing on a new era of securitization and with it a new round of structured instruments designed to get around the new accounting rules.

The FASB should be disbanded, then tarred, feathered and placed in stocks in front of the Bear Stearns building.

John Hamilton, CEO
Charles River Bank, Medway, Mass.

Air Force Model May Fly in Credit

BY ERIC LINDEEN

For most lenders, making changes to credit policy is not an easy or quick process.

In a recent survey by TowerGroup, 93% of financial industry executives said it takes at least nine months to develop, test and deploy a credit risk policy concept.

The majority of the executives polled (64%) said that this process takes their institution 12 to 18 months. This time lag presents a significant challenge, because taking so long to develop and implement new policy is ineffective in today's economic climate.

There is a desire within the financial services industry to speed up this development cycle. However, many believe it is impossible to do so without affecting the quality of the final policy.

With the right technology and supporting business strategy it can be done. To make decisions more quickly, accurately and safely, credit risk executives can learn from an approach that fighter pilots employ — the "OODA loop."

Retired military strategist Col. John Boyd of the U.S. Air Force originated the concept to help fighter pilots hone decision-making skills and improve proficiency during battle.

The OODA loop dictates that in any decision-making process these four steps must occur: observe, orient, decide and act.

The key is executing your decision-making loop more quickly than your competitors and improving your outcomes with a faster cycle.

The "Top Guns" of the Air Force have mastered this strategy; they trap their rivals in their line of fire before the competition even has time to react. Lenders can use the same decision-making technique to develop credit risk policy. By employing this technique in a continuous development cycle, institutions don't need to rely on policy implemented once every few years.

The OODA loop cycle for credit risk managers looks something like this:

- Observe what is happening in the market and in the portfolio.
- Use performance data to orient their institution in the right direction.
- Decide on the next steps by testing and validating theories based on that data.
- Act by implementing new policies quickly.

"For lenders, the most important learnings from the recession are that historical lending models, collection metrics and financial planning tools are imperfect and that market conditions, consumer purchase behavior and demographics have changed," Bobbie Britting, research director of consumer lending at TowerGroup, said. "New business models require continuous learning based on timely feedback loops to ensure the models remain effective and in sync with economic shifts and changes in consumer purchase behavior."

In today's volatile market things are changing more rapidly than ever before, which means the best-laid plans will be outdated before they can be implemented. To stay ahead of the game, and out of the line of fire, lenders must cut time and cost barriers that stall productivity, and be nimble enough to make changes as the market and consumer behavior fluctuates. We are living in times that require more progressive strategies.

Adopting a new business strategy for credit risk policy development improves outcomes for lenders by making the cycle a more continuous process rather than a project undertaken every few years. This may ease collection issues down the road by helping lenders make better credit decisions up front. In addition, the same strategies can be used to support a quicker response time when identifying consumers on the verge of getting in trouble.

Eric Lindeen is the director of marketing at Zoot Enterprises.