

## The Origins of the Banking Crisis

By Demetrie Comnas

*It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country-*

Adam Smith



*And lead us not into temptation.....*

Jesus

### A Short History

The current economic crisis and the failures within the financial services industry are not the result of poor market risk management, as much as they are the result of poor credit risk management. One of the areas that became particularly weak within the financial sector over the last 20 years is credit risk management. This applies both to financial institutions, other loan origination entities, and the regulatory bodies that oversee them.

During the 1980's and 90's, Glass Steagall legislation was being systematically dismantled, so that commercial banks could expand their core lending practice to include more and more traditionally investment banking activities. This was pursued in the belief that economic returns in the lending business were artificially constrained by the segregation of financial product lines between the two industry segments, unfairly favoring the investment banks, and making it difficult to attract needed capital into the commercial lending side.

A host of rationales were assembled in order to justify the removal of the very same safeguards that had been installed in the aftermath of the Great Depression, in order to allow the modern banking industry to evolve in a more integrated fashion, and to remove any impediments to economic growth that the old system may have had.

In their attempt to develop competitive strengths for their new-found powers, commercial banks looked to their traditional loan origination capabilities in order to produce products that could be attractive to investors, the constituency that would be critical to their success as investment bankers. If they could produce attractive products that the legacy investment banks could not, they would gain leverage with investors, and issuers, that they could use to gain access to other lucrative areas of financial intermediation, such as bond and equity underwriting.

Not having yet gained the confidence of corporate issuers to underwrite their bond and equity issues, commercial banks took what assets were on their own balance sheets and securitized them so as to have the look and feel of the securities that were traded in the

capital markets. Starting with their high quality assets, they slowly made in-roads within the investor community, and in the process discovered that the returns were much better than traditional portfolio lending, mostly as a result of the reduced capital required to support business that ended up off the bank's balance sheet. Once they had demonstrated their ability to produce and distribute plain vanilla securities, they looked for ways to further improve returns. They then started playing around with lesser quality assets, and found that by pooling them, and adding a few bells and whistles, they could make credible arguments about the portfolio effect of the pools, and the high collateral levels, to get investors interested.

The focus had begun to swing from the borrower to the investor. This was to prove to be perhaps the single most significant change in the culture of banking, and brought with it a fundamental shift in priorities, values, systems, rewards, and viewpoint. The process of originating debt was no longer just to serve the needs of the borrower, but was now perhaps more to serve the needs of the investor. Originate and hold had become originate and sell, which eventually became originate to sell.

Critically, they had also learned that the faster you could originate and distribute the paper, the better the return on capital employed. A new virtue thus entered the commercial banking culture and lexicon....speed.

On further investigation, it became clear that the speed of financial intermediation was a direct function of the potency of one's sales organization. The more effective you were at selling, the better terms you could offer the borrower, the better the skim you could take on the turn, and the more turns you could do over time. So, if speed is a function of selling power, what makes for more selling power? The easy answer would seem to be having lots of investor clients and lots of salespeople, but the investment banks and brokerage houses were the ones who had these, not the commercial banks. So, they searched for another solution.

### Complexity Equals Higher Margins

Like in many other businesses, if you can offer your clients a wide range of products, they are more likely to find one they want. This principle was behind the pressure the commercial banks felt, and the pressure they placed on government to give them access to broader and broader securities powers. This principle also led them to look within their traditional businesses for other elements they might add to traditional securities to enhance them by producing hybrid effects that could be customized to the appetites, and increasingly to the speculative urges, of their target investors. These add-ons were derivatives. At first, simple derivatives on currencies or interest rates were incorporated into basic securities to tart them up. Eventually, these add-ons became extremely complex, and took on a life of their own.

Banks that were used to trading FX and currency derivatives with corporate borrowers and other financial institutions quickly saw that most investors knew little to nothing about how to price derivatives, particularly complex ones, and that huge margins were available. The margins on the derivative add-ons were often far greater than the margin on the underlying financing transaction. The learning point here was that in order to keep profit margins wide, the game is to keep adding complication to the product, by imbedding as many derivative features as possible, making fine pricing impossible. By and large, most investors didn't have the multi-market access, or the computational sophistication to independently price the financial constructions being offered, but they sure loved them!

Banks could make huge profits not only by originating debt, onto which they could add on these complex features, they could then trade these complex instruments in the secondary market over and over again, taking a good profit each time the product changed hands. Not only that, they had created a market for the add-ons alone, without an underlying financing transaction. After all, their clients may want to change the profile of their risk exposures, independently of their interest in the underlying investment, independently of their "asset" portfolio per se. If not, perhaps they could be convinced to.

Investment managers and issuers alike became profoundly intrigued by these add-ons, as they could significantly reduce financing costs or enhance portfolio returns. For investors, the underlying financial assets became essentially irrelevant, as long as the add-ons were available to offer similar, often better, and more tailored risk/return dynamics derived, supposedly, from the same underlying economy. I say supposedly, because as the size of the market in add-ons grew and grew, it eventually dwarfed the size of the underlying economy by a factor of roughly 80 to 1, and became a virtual economy of its own. The notional value of bets in the derivatives markets currently totals something like a quadrillion US dollars, compared to US GDP of just 13 trillion. Investment capital is not just being intermediated between savers and borrowers, but is being put into this virtual economy, the casino of side bets, the derivatives markets.

One of the rationales that had underpinned the dismantling of Glass Steagall, i.e. to remove impediments to capital formation for commercial lending, ironically had resulted in the allocation of huge amounts of both financial and human capital to entirely non-economic purposes, to the virtual economy. How did this happen?

Complex games that offer high stakes, few restrictions and secure payoff mechanisms will attract both capital and talent. Complexity offers players at several levels the opportunity to exert informational and/or computational advantages over other players. It also provides a hospitable medium for gambling compulsion, as truly no one has all of the answers.

## Where the Wheels Came Off

Going back for a moment to the commercial lending business, the business of financing businesses and households, it had become harder and harder to find true portfolio investors for these assets. By portfolio investors, I mean people willing to hold these assets to maturity, the way commercial banks used to do themselves. More and more classes of commercial risk had become securitized and had found their way into the public capital markets, actively traded alongside all the other so-called liquid investment products. Theoretically, there is no need to hold such a security to maturity, as it can be actively traded, even day-traded, in search of higher returns.

This is where the wheels came off, as far as I am concerned. Consciously, or unconsciously, the thinking went something like this: *If I am not required, or even likely, to hold these assets to maturity, then what level of analysis is necessary to prudently trade in them? As long as I can sell them in short order, why should I care about the long term viability of the underlying enterprise? All I really need to worry about is the short term market risk of this asset.* Concern about the long-term viability of the underlying enterprise used to be the domain of the commercial banks. This had been their bread and butter; this had been their purpose in the capitalist system, to analyze, to monitor and to react to developments that affect the long-term viability of enterprises. Why, because they were going to be stuck with the debt, and therefore had better be sure from the outset that the enterprise was going to be healthy over the longer term. This role has since been abandoned by the banks, in favor of short-term market risk analysis and short term trading position management. The traditional credit risk management culture of the commercial banks has all but been destroyed in the process, replaced by a sales culture, whose underpinning are the “greater-fool” theory, leaving no wonder as to why so many severe problems go unnoticed until it is too late.

When credit instruments became the feedstock for asset-backed securities, the fundamental credit analysis, institutional safeguards and even the most basic precautions that used to be integral to the lending business, those designed to ensure long term portfolio health, were replaced by considerations of salability, backed by statistical modeling that may have once been sound, but which evolved and mutated so as to justify increasingly specious concoctions of risk and unnatural economic segmentation. Meanwhile, the derivatives markets, the shadow economy, continued to expand. The casino grew to ludicrous proportions. The complexity of investment products and the metamorphosis of add-ons surpassed absurdity, as feeding greed and gambling compulsion overtook genuine industrial and household development as the true purpose of financial intermediation.

The immeasurable leverage that was brought into the system was a disaster waiting to happen. The replacement of long-term credit risk management by short term market risk management was another disaster waiting to happen. The enormous wealth opportunity for people willing to take inordinate risks with other people’s money was a third disaster waiting to happen. What we then got was the inevitable perfect storm. Risks piled onto bank balance sheets “awaiting distribution” that never happened. Mutual funds, pension funds and individual investors chased hypothetical values that had no foundation in long

term economic reality. Drinking their own Cool-Aid, they blew the biggest asset bubble of all time, which eventually popped.

In a nut-shell, that's what happened.

## Size Isn't Always Everything

If we look at the investment banking (IB) business, we can see that it involves greater risks and greater return than does traditional commercial banking. The IB business used to be the purview of private partnerships, risking their own funds, without the ability to take deposits from the public, and relying heavily on commercial banks to finance their positions, which used to be done on a fully collateralized basis, with strict leverage restrictions imposed by Federal regulations like Regs U and G.

This deserves repeating, so let's review what was just said. This riskier business was done by private firms, risking primarily their own money, and limited in the degree of leverage they could take on. This actually makes some sense. People are less likely to be reckless with their own money, and more watchful of others in the company, to make sure they don't squander it. The culture's precautions and climate of scrutiny were commensurate with the business risks.

Leverage restrictions, concentration restrictions and collateralization imposed additional discipline on these firms to maintain a healthy degree of diversification, and disaster-proof capital adequacy on a daily market-to-market basis, thereby virtually eliminating the likelihood of overextension, overtrading, and security asset bubbles. Hey, this sounds pretty good. Why, on Earth did we want to abandon this kind of regime? In hindsight, the answer is clear: greed, avarice, laissez-faire beliefs, and all the typical vanities that regularly bring us to grief.

What happened? Well, to begin with, investment banks, faced with these huge new entrants into their domain, realized that they would have trouble competing on sheer size, unless they could radically add to their capital base, and therefore went public. In the process, they removed one of the key safeguards; they were no longer only playing with their own money. Stock options and phantom stock awards notwithstanding, the basic incentive structure had been radically altered, as the linked fates of erstwhile partners were severed, in favor of independent mercenary professionals, seeking the largest pile of capital with which to speculate, in the hopes of grabbing their personal brass rings and getting out. Downside risk had been fundamentally altered for this entire class of professionals, and no one comprehended the potential outcomes of such a change. Mercenary behavior became the norm, and traditional investment banking reverence for capital preservation and expense control went by the boards.

As the partnership structure evaporated, and commercial banks were allowed to merge with investment banks, gun-sliding mercenaries sold their talents to the highest bidder,

in an ever frenzied rush to get rich and get out, hardly the sort of mentality one would choose to safeguard one's wealth, and certainly not the mentality one would want handling the public's savings deposits. As bank executives sought to hire and retain their big guns, personal compensation achieved ridiculous levels, and long-term career minded behavior became endangered specie.

Secondly, with capital efficiency hampered by regulatory restrictions, these talented individuals invented methods of transacting in over-the-counter off-balance sheet instruments, thereby avoiding leverage constraints as well as the forced transparency of the mark-to-market discipline.

## A Wolf to Guard the Sheep Shed

As the complexity of trading instruments expanded, only very few even pretended to understand them, and the regulatory community became increasingly helpless and intimidated by the mathematical gymnastics of the trading elite. Awed by the academic credentials, and huge salaries of the PhD traders, regulators were lulled into a state of mystical faith in the obscure convoluted mathematical models that had been "engineered" by this clearly superior class of ostensibly competent professionals, and steadily relinquished their responsibilities to an industry they believed capable of self-regulation. How patently absurd to believe that an industry focused solely on money could avoid the sins and excesses of greed, without outside controls.

Similarly, the accounting profession and the rating agencies bowed to, and occasionally conspired with, these geniuses, as the opportunities for personal gain became exaggerated. Conflicts of interest were overlooked, ignored and easily exploited, not only within the fully-integrated financial institutions, but between them and their auxiliary institutions, the accounting firms and the rating agencies. Paper-thin Chinese walls proved too often to be insufficient to hold back the tides of greed and avarice when faced with such clear opportunity. Trading excesses occurred with greater and greater frequency, as the culture of prudence and modest gain was replaced with an unmitigated devotion to Mammon.

Amazingly, the current thinking on how to save the financial services industry, in particular the investment banks, is to force them to take on commercial banking licenses, immediately granting them deposit gathering powers. (That's retail depositor's money.) Let's see now; we have a compulsive gambler, who has run amok. Let's give him a larger pile of cash which, because it will cushion a huge amount of bad bets, should avert any failures; and let's hope that over time he will change his ways and become a prudent investor. I don't think so.

## Avoiding the Dreaded Hat-Trick

Well, we can't keep doing things the way we have and expect better results. Our understanding of business and economic behaviors must evolve, as should the market mechanisms and financial institutions that engage and service them. We have been this way before, and believed we had learned our lesson. Our defenses have been breached twice, once with the events leading up to the Great Depression, and again most recently. There are some highly valuable lessons from the past that must not be ignored. Some of these were learned after the first Great Depression, and since forgotten to our chagrin. Will we learn them this time, or will we remain vulnerable to the dreaded hat-trick? That's perhaps the first lesson, not to so easily abandon lessons learned in the past. That said, perhaps some of the safeguards that have been removed should be put back in place. Not a particularly revolutionary idea, and maybe too obvious, but definitely worth considering.

If we catalogue the areas that have contributed to the current state of crisis, we would include the following, in no special order:

1. The elimination, evasion and flouting of leverage restrictions
2. The elimination of long-term investor disciplines
3. Short-term incentive structures for professionals and managers
4. Disproportionate rewards for risking other people's money
5. Non-economic (purely speculative) purpose to investment products
6. Market risk analysis replacing credit risk analysis
7. Mercenary culture, whether it be among professionals, managers, or CEOs.
8. Lack of reliable and transparent pricing brought about by unnecessary complexity
9. Conflicts of interest not adequately sequestered.
10. Regulatory indifference and indolence

Clearly, these problems span a wide range of domains, from simple accounting to portfolio strategy, institutional skills, regulatory and legal frameworks, compensation regimes, industry structure and business culture. It's a complicated mess, but we can, and must, rebuild our financial institutions since the health of the global economy rests on a solid, prudent, trustworthy banking and financial services industry.

What can the leaders of today's battered banks and financial regulators do?

They operate in this maelstrom, and despite all of their efforts to paddle away, they are caught in it as much as anyone. They have been responding to crisis after crisis and wondering when and from where the next one will come. Some would like to believe that they are better off than most, and hope that this will be enough to get them by. Their responsibility, however, is to know, not just to hope, and to rebuild their institutions so that they can survive and thrive in this new world economy. Where to begin?

Bank CEOs and industry regulators might begin by looking for answers to the following questions:

How can we ensure that banks retain a long-term stake in the financing structures that they originate?

Are we allocating human and financial capital to economically productive purposes? Do we really want to continue as the world's casino?

Are our employee (and executive) compensation structures conducive to long-term value creation?

Do we serve the long-term needs of our clients?

Are the penalties for abuse and irresponsible behavior sufficient deterrents?

Are our regulators equipped and staffed adequately to protect our industry from its own tendencies to excess?

Is the structure of our industry compatible with depositor protection? Is it compatible with the standards of transparency and fairness that the public expects?

As the key sub-culture of the global industrial culture, do we reflect the values that drive innovation, accountability, collaboration, productivity, social responsibility, and integrity?

What sort of behaviors and values do we model and reward, and are these consistent with long-term economic growth and competitiveness?

There is no easy prescription to curing the cumulative effects of decades of misguided institutional governance, however, by living in questions like those listed above, we can invent a future that avoids many of the problems we regretfully chose to revisit upon ourselves yet again, and can avoid the dreaded hat-trick.