Risk Management: The Current Financial Crisis, Lessons Learned and Future Implications

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Disclaimer

- The views expressed in this presentation are solely those of the author

“Lessons Learned”…

- Before we can “learn lessons” from an event…

- …we must be acutely aware of potential pitfalls and biases in our analysis

Pitfalls in “Lessons Learned”

- Fallacy of hindsight
- Fallacy of myopia

Hindsight

- We know stuff now with perfect clarity
  - But we did not have perfect wisdom before the blowup

- In future crises, our “perfect wisdom” will continue to arrive only <u>after</u> the blowup

- Solution: let’s focus on what we can do to “improve our chances” before the blowup

Myopia

- Myopia:
  - No ability to see broader landscape
  - Focus on idiosyncratic aspects of this particular crisis
    - "Blowup was because of housing bubble and irresponsible bankers; no analogy to P&C insurance"

- Solution: let's focus on those aspects of the crisis that have broad application

Lesson Learned

- Include the cost of downside risk
  - When measuring profit for financial statements
  - When measuring profit for compensation purposes

Include the Cost of Downside Risk

- Creates internally generated incentives to consider profit on a risk adjusted basis
  - Incentives can shape behavior of risk takers before a blowup
    - On some deals, the cost of downside risk would wipe out the potential profit gain
    - Would extinguish the internal incentive to pursue the overly risky deal in the first place
    - Would limit the extent of future blowups

Incentives

- Given the errors in modeling risk, how can including the cost of downside risk ever work?
- The incentives created by including the cost of downside risk are somewhat robust to model error
  - Did it turn out that measured downside risk was too low? Yes [hindsight is perfect]
  - But had we included the cost of downside risk, even if understated, we would have avoided a lot of the worst decisions

Incentives

Example #1:

- What was one of the reasons for the huge demand for structured products such as CDOs?

- Asset managers and fee structure incentives
  - CDOs provide excess basis points of yield relative to benchmark assets
  - Some asset managers compensated based on extra yield vs benchmark
  - Benchmark based on expected default rate
  - Apriori we could have seen that the downside risk of CDOs was much more pronounced than bonds
    - Small change in underlying default rate assumption = small decrease in bond value
    - Small change in underlying default rate assumption = huge decrease in CDO value
  - Had the cost of downside risk included in profit measurement, it likely would have more than offset the extra basis points earned by CDOs
    - Even using the understated view of risk prevalent at the time
    - Would have been less incentive to invest in them
    - Would have lessened the severity of the crisis

Incentives

Example #2:

- What was one of the reasons for the huge <u>supply</u> for structured products such as CDOs?

- Banks' incentives
  - Securitizing and issuing CDOs generates lucrative fee income
  - To create CDOs, banks securitize the high quality tranches to investors
    - Need to keep the riskier tranches for themselves
  - Fee income shows up in the Income Statement
    - Income statement does <u>not</u> include the cost of downside risk of retaining the risky tranche
  - Had the cost of the downside risk from retaining the risky tranches been included in profit measurement, it may have offset the fee income of issuing the other tranches to investors
    - Even using the understated view of risk prevalent at the time
    - Would have been less incentive to create these "sausages"
    - Would have lessened the severity of the crisis

Incentives

- Does GAAP accounting reflect the cost of risk?
- Does GAAP accounting create incentives for risk taking?
- Does GAAP accounting create incentives that are contrary to public policy?

Avoiding Myopia

- Do any of the issues raised in this discussion apply to P&C insurance?
- Does P&C insurance accounting reflect the cost of risk when measuring profit?
- Do P&C insurance enterprises include the cost of downside risk when calculating profit for compensation purposes?

Summary – Lessons Learned

- When measuring profit, include the cost of downside risk
  - Affects incentives
  - Influences behavior
  - Helps reduce the likelihood and severity of future blowups
- Many aspects of the current crisis are relevant to P&C insurance as well