

## Reflections on the US Financial Crisis: Risk Policy Ignored

ARPI has been following the developments in the US financial crisis for some time and Admiral Chris Barrie AC (Rtd), Patron of ARPI, spoke at length about the Sub Prime portion of the crisis in July this year at ARPI's winter seminar ([www.arpi.org.au](http://www.arpi.org.au)).

Recent developments in the financial crisis deserve an updated comment from the perspective of risk policy. Risk policy is a new concept in some parts of the world, but in Australia, ARPI has taken the lead in developing a clear understanding of the subject. Risk policy is a totally different concept from having a policy on risk management, or even risk management policy. Risk policy looks at the baseline structure of the executive decision process, and builds an integrated framework within it that makes risk an integral, seamless part of that process. To put it into its simplest element, risk policy is all about likelihood and the context surrounding it.

Understanding that context is the first key, and putting forward the prospect of integrated risk as part of contextual gate maintenance (allows the gate to open without squeaking, i.e. without reputation or other substantive risk emerging) as opposed to gate keeping (locking the gate and holding up the risk key as a talisman) is most important. A simple example will illustrate the point. In mid 2004, the then head of risk management at Freddie Mac sent a memorandum to the then chief executive saying, amongst other things: that "the firm's underwriting standards were becoming shoddier and that the company was becoming exposed to losses would likely pose an enormous financial and reputational risk to the company and the country."

According to confirmed sources, the chief executive responded that "he couldn't afford to say no to anyone." The risk manager promptly left the organisation. The chief executive's ultimate response this year was: "If I had better foresight, maybe I could have improved things a little bit. But frankly, if I had perfect foresight, I would never have taken this job in the first place."

The problem there was conflicting goals: on the one hand to buy bundles of mortgages relating to mortgage loans that had been provided to low income people, to meet the government's policy objective of affordable housing. On the other hand, the company had to appease regulators. It claims that it could not do without either compromising one or the other.

However, risk policy was put on the table and ignored. The same thing happened across the board in relation to the sub-prime crisis. Mortgages that could never be repaid were approved. Brokers' fees were paid. The risk was ignored. The mortgages were syndicated, bundled, and sold. At each step, intermediaries were paid. Bonuses were paid. Risk became more and more concentrated at each transactional development, but was ignored.

Compare this to the Australian situation. Here is an example. In June 2008, the Australian federal government put aside \$4 billion to support competition in the non bank mortgage sector. While they announced the measure on 26 September 2008 the government clearly had anticipated having to deal with the issue at a future time. The time came, action followed. Not only that, but the engagement bandwidth is such that taxpayers will be protected and ultimately rewarded for their (involuntary) investment in AAA rated debt in lieu of cash.

The advice to put aside funds would have come from Treasury. To be sure, the recommendation would have involved regulators, APRA and ASIC as input participants. However, the primary advice must have come from Treasury. The advice also had to have

been frank, objective and based on a number of anticipatory factors, but likelihood, in context, would have been front and centre in the decision and recommendation process.

Compare this to two things: the US Treasury US financial market bailout proposal and the multifaceted and complete failure of both market and regulator that brought about the crisis in the first place.

Taking the latter first, and looking at sub prime as a catalyst, applying risk policy concepts would have provided an accurate assessment of inherent risk as part of the originating decision process. There were three decision points at which the pre-emptive application of risk policy might have been able to assist in preventing the crisis. The first was at the point of approval of the mortgages, the originating point of the crisis. The second was at the time the NORMA (Norma CDO I Ltd) was created, the original (derivative) collateralized debt obligation product that bundled the subordinated debt. The third was at the time that derivative was purchased, rated and traded.

Risk having been ignored at those three critical junctures, the head of steam built as a direct consequence of the perceived benefits (mainly fees, bonuses and paper profits that enabled the major players to take on further debt in order to acquire even more sophisticated assets outside their areas of expertise) of such financial product innovations proved unstoppable until the whole virtual Ponzi scheme ground to an unceremonious halt and Merrill Lynch, the money market titan that first picked up the NORMA from its penny stock broker inventors and ran with it, is no more.

Enter the US Treasury, headed by one of Wall Street's own and lumbered by a fixed, immovable political millstone: "free market good, regulation bad." The SEC has now confessed to a failure of regulation, even of failure to insist on adherence to the most basic filing requirements. Accordingly, Hank Paulson, secretary of the Treasury put a bailout proposal to government that simply would absolve the financial institutions that caused the problems from responsibility, and foist the problem on existing and future generations of taxpayers. The logic is that the problem is too big to allow the causative system and entities to fail and the institutions do not have sufficient available capital to help themselves and provide capital to the markets at the same time.

The proposal has degenerated into political wrangling and the financial markets have been correspondingly volatile. No wonder; reports have emerged that some firms are looking to find ways of making profits out of the bailout itself. Nothing is being learned at present and Paulson ruefully looks at the "twin towers of regulation" in Australia as the paradigm the US should have followed and should now consider.

Compare that to what has happened in Australia where the major concern is between the government and opposition as to which of them came up with the good idea first! This petty squabble belies the fact that it is both major parties that can rightfully claim responsibility for the creation and maintenance of sustainable financial regulatory frameworks. Twelve banks in the world presently rate at AA or better. Four Australian banks are among the group.

ARPI believes the US government should adopt and replicate the balanced open market/regulatory model used in Australia, acquire significant or controlling equity stakes in every entity that receives one dollar of taxpayer funds, force every potential beneficiary to write down its losses to the baseline value of the underlying mortgage properties before receiving its first dollar and issue warrants to the government. Second, control executive remuneration. Eliminate any spectre of bonuses, incentives, or retention payments to executives of those entities. In that way, taxpayers stand a chance of a return on their investment from both the sale of distressed assets and ultimately, the sale of stock as the market stabilises and the beneficiaries are released from public hands.

At least at this stage, risk policy having failed, risk management can operate, with the prospect that for the future, risk policy will be part of the fundamental decision matrix, not a

theory. The next question perhaps is whether risk policy should be mandatory – either in application or public reporting – if it continues to be ignored at executive leadership level.