Not so immaculate conceptions

BUTTRESSING THE ACT OF FAITH THAT IS BANKING AND INVESTMENT IS A SET OF ASSUMPTIONS THAT DON'T ALWAYS HOLD WATER. **STEPHEN BASEBY** EXPLAINS.

In 1453 Emperor Constantine XI threw off his imperial regalia and plunged into the raging battle to save Constantinople, and was never seen again. Over 500 years later, in 2008, US realtors, as estate agents are called over there, listened to the tinkle of keys falling through their letterboxes as folk headed back to the trailer parks and rental blocks. Both the Emperor and the realtors had failed.

The Emperor's risk management process had been immaculate, based as it was on the assumption that God would intervene. The Byzantine Empire may have shrunk over the centuries to just one city, have only 7,000 ragged defenders against an army of 80,000, and be facing an enemy in Sultan Mehmet II who had a long-range cannon built to chip away at walls that had stood for nearly a thousand years, yet the Emperor had God and that would suffice.

The realtors and the chain of brokers, bankers, bond dealers, rating agencies, bank supervisors and ultimately investors also based their faith on an immaculate assumption: that people want to own their homes, and will scrimp, save, cut corners, and eventually beg and borrow more to ensure they do. On this assumption sat the great push to get the US rental community on board the mortgage train and their mortgages into collateralised debt obligations to be sold on

to professional investors who confused long-term credit ratings with short-term liquidity.

Risk management failed both the Emperor and the realtors. Each had predicated the future of themselves and their neighbours on one fundamental but ultimately flawed cultural assumption.

THE MOST SUCCESSFUL RISK MANAGERS WERE THE TRAILER FOLK: AT WORST THEY ENDED UP BACK IN THE TRAILER PARK, AT BEST THEY WILL EVENTUALLY OWN HOUSES.

The realtors, bankers, bondholders and the rest had spreadsheets, credit analysts and their matrices, prospectuses, Powerpoint and regulation. The conviction that no American would let their house go without a fight was as absolute to the realtors and their lawyers living in the comfortable suburbs of provincial towns, the bankers living in sleek Manhattan apartments and luxurious Hamptons villas, and the regulators living in genteel Georgetown, as the knowledge that God was on his side was to the Emperor. But God did not intervene on the Emperor's behalf. And working-class Americans took their welfare and wages cheques and returned to trailer parks and rental apartments.

DRIVEN BY CHAOS There is a long-running gag (believe me, I'm old enough to know) that the only rule is that there are no rules. Nature is chaos and chaos brings forth random results: that was the bit that Darwin got right – that chaos is evolution.

We make rules. We make them to protect what we have and whenever our ownership becomes tenuous. Governments pass laws. Banks and corporates develop governance. Financial markets waver between self-regulation and blaming governments for failing to regulate them. Tax accountants work out the gaps in the laws. Tax lawyers charge a fortune to defend the tax accountants' clients. But these laws are our laws. We base them on our beliefs, our assumptions and our culture of the moment.

Much work is being performed in corporate treasuries on the analysis of counterparty risk. We pre-borrow to avoid exposure to debt markets; we hoard cash and then we worry where to hoard it. We micro-analyse banks: we read the credit analysis, we monitor the ratings, and we monitor their CDS – Bloomberg is a blessing. We are relieved when a bank stumps up for our deposit on a house and then we worry why it did so. We tut over the risk of placing deposits with banks while we ask them for credit facilities, and we moan about their margins, which are fat to reflect the capital they must hoard in government bonds to protect our deposits and the availability of our credit lines.

We keep an eye on the gilts market: that will be safe even if we are losing money over inflation and the yields are too low to reflect any possible outcome for the British economy, probably so low because banks and pension funds are required to hold so much of them, which is why their credit margins are expensive and corporates are closing down their final salary scheme.

Counterparty risk is not new. Edward III understood default. He knew how to treat bankers when the debts he took on to finance his wars became too much: don't pay them. And he didn't. The Medici are known so well today because the other 13th century Swiss and Italian banking houses that lent to Edward were permanently scarred by the English default. The Medici survived. We disparage the Argentines, but they may simply have learnt from us.

I will not propose a law, but an axiom: any and every debtor can default. Not "will", but "can".

Banking and investment are little more than acts of faith. Like Constantine we choose our faith and tend to stick with it even when the results start to worry us. Barings Bank had governance but overrode it, wishing to believe the dealer could be right. Sumitomo Corporation had governance but dealer Yasuo Hamanaka evaded it for 10 years until his unauthorised copper trading lost the company $1.8bn in 1995.

Today we are wary of the banks of the emerging mega markets. The BCCI experience didn't help but those banks are the home of the surpluses fed by our deficits. For proof of that, try placing a deposit with HSBC and see what you are offered.

MY WORLD, YOUR WORLD Our traders don't like the currencies and debt of the emerging markets. They do not have our governance, our rules, our laws, our enforcement, our culture. We have governance and we have enforcement – and we had Northern Rock, Bank of Scotland, Royal Bank of Scotland, Barings, and for that matter Rover.

But the government assumed that the FSA with its teams of fresh-faced accountants would be a better bet than the time-proven, battle-scarred Bank of England, and that the hope of preserving all jobs at Rover was better than the plan that sought to preserve Rover. Barings meanwhile assumed that its rogue trader Nick Leeson had magic insight.

Sumitomo Corporation missed the point of confirming deals, as do so many institutions operating in London today. Back when the Old Lady ruled the banking roost, a thin A4 booklet set out in detail how banks and their counterparties were to conduct themselves when dealing. I recollect receiving my copy from a gentlemanly chap after I and one of my ex-bosses were summoned to the marbled halls for a chat about the frowned on practice of arbitraging the short-term bill market, and then given a fine lunch in the Bank's own restaurant, presumably maintained for the purpose of putting uppity commercial folk in their place. This fine booklet may continue to exist but some London trading banks have little regard for its pernickety contents.

CULTURAL MYOPIA Which countries' banks kept their capital adequacy in safe territory throughout the credit/bank/bond crisis? Thailand and the Philippines. The worst culprit was that most Westernised of Asian countries, Japan. Michael Pomerleano's "What Is the Impact of the Global Financial Crisis on the Banking System in East Asia?" in 2009 for the ADBI makes sober reading for those who see their futures only in the cultural womb of the Western economies.

How many Asian banks were nationalised in 2008 to save their host country's economies? Buying safety for one's banks is sadly a European and US option for survival.

The most successful risk managers were the trailer folk: at worst they ended up back in the trailer park, at best they will eventually own houses.

Stephen Baseby is deputy treasurer of Severn Trent.