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Where Were the Risk Managers?

May you live in interesting times. This old quote often has a double meaning, in that it might be interesting to read about but disastrous if you are living it out. This is the case today with a risk often referred to by the media as the sub-prime crisis. Homeowners with little ability to pay a mortgage were welcomed by brokers who abused rules designed to help business owners. The mortgages were then securitized into residential mortgage backed securities (RMBS), awarded credit ratings that varied by tranche, and sold to investors. Each of these groups played a role in the recent financial upheaval.

Many in the financial services industry are trying to sell this as yet another “perfect storm” that could not have been anticipated. While many were writing about an impending housing bubble, those making money off this market continued to argue that the market must be right or else the bubble would have already burst. The reality is that there were plenty of warning signs that could have been heeded, and were by some. This article will provide some general background and encourage the reader to make their own conclusions about whether the scenario that actually occurred should have been considered.

Those most hurt were the low-income, unfortunately temporary, homeowners who are most susceptible to foreclosures. Just a few years ago this segment of the population was ravaged by a similar event in the manufactured homes market, with a marketing induced name of affordable housing. This is the mobile home market, but sounds like sub-prime to someone doing research today. Dealers sold “double-wides” and extra features when the buyer could not afford the base model since their commissions were based on volume and not reduced by future foreclosures. Lenders such as Green Tree incented the dealers further to sell loans. Once defaults started the bubble had burst. This event should have provided a warning to the financial sector. Instead, home brokers learned the tricks of the trade and investors and ordinary people eager to buy their first house did not.

Several investment banks have recently taken write-downs on their mortgage loan portfolios. These sophisticated investors have become so short-term focused that they took the few extra basis points and ignored the longer term risks related to default, contagion, and liquidity. Over short time horizons their trading book looked like they were earning excess returns. As defaults rose, so did spreads. At the same time, liquidity fell as eager buyers became few and far between.

Enterprise risk management was supposed to take care of these risks, allowing those who followed best practices able to avoid these periodic blowups and perhaps profit from them by taking contrarian positions. More so-called sophisticated investors lost money than made money. Why?

Culture: Effective ERM requires a company culture that encourages risk when the firm is paid for taking it and discourages it otherwise. Sometimes the same opportunity can make sense in one environment and not in another. When senior management is incented for recent results and goals are set each year it makes for weak risk management practices. If the bet pays off the manager gets a big bonus, and if it doesn't the owners take the loss. Egos also play a part. If the senior manager thinks they are smarter than the risk manager, and don't have to listen to him/her, they won't. Companies always seem able to find ways around exposure limits, especially when there is no transparency required.

Tail risk: Default risk between entities is not independent in the tails, yet most models assume that you can diversify your risk by spreading it over a large number of firms. Not true. If foreclosures spike up, there may be some regional diversification, but you should not rely on it. With a national slowdown in the housing market, regional differences will emerge related to the amount of the changes in housing pricing, but not on the direction. As with many distributions, the farther out in the tail you get the more dependency there is between events.

Relying on others: Many investors relied on the rating agencies for analysis that should have been done by the entity providing the funds. Once the market tanked, these investors were surprised that what was often rated a AAA credit could have so many defaults. They did not understand the risks they had taken. Perhaps those who relied on the rating agencies should give them their bonuses over the past several years prior to the implosion. Many investors are blaming the rating agencies, but the reality is that they should never have invested in these assets without doing their own analysis, and this was impossible without better transparency. In addition, the rating agencies attempted alchemy by saying that diversification occurred in this market by combining several issues into a Collateralized Debt Obligation (CDO) and rating it higher than the combined underlying securities.

Misaligned incentives: The financial markets work efficiently when all the incentives are aligned. In this case they were not. Brokers were paid for volume, with no incentive for the homeowners to pay off the mortgage. They passed the risk on to government sponsored enterprises like Fannie Mae and Freddie Mac, who rolled them up into securitizations, segmented them into tranches and sold them. Had they not kept some of these assets in a trading portfolio they might have avoided the worst of the crisis, although when liquidity dried up they would have had trouble passing along new issues.

What can we learn? If the market prices in additional spread for a risk, it is there for a reason. In this case you could earn a few extra basis points for an investment rated credit, but there was tail risk, liquidity risk, and model risk that was not appropriately included. These risks had been seen before with the affordable housing crisis, but little seems to have been learned except by the mortgage brokers who used similar practices to line their own pockets. Those who hold the risk can ignore that risk only at their peril.

Emerging or Mispriced Risk: Recent bubbles have been described as "Perfect Storms" that could not possibly have been anticipated. Risk managers generally think this verbiage is designed more to cover someone's a** rather than actually be helpful. A good risk manager should develop scenarios that "could" happen and determine what the impact would be. There were enough articles written about the possibility that housing was in a bubble that popping it should have been considered. Some sophisticated investors actually took a bet in the other direction and did quite well. Risk management is not about eliminating risk. It is about taking transparent risks that you understand and are paid to accept. If those conditions do not exist then the investor should walk away from the opportunity or at least try to reduce the exposure as much as possible through mitigation techniques.

The housing market may have been created by low rates created by the Federal Reserve. Surely it was an unintended consequence of providing liquidity after the stock market bubble burst. Are we in a cycle, where one bubble bursts, the Fed provides liquidity, accidentally creating the next bubble? Should we let the chips fall where they may the next time to allow proper risk incentives to reappear? Only time will tell.

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