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FINANCIAL CONSULTING LLC

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Regulation

The Financial Services Modernization Bill, now adorned with the names of Barney Frank and Chris Dodd, attempts to make things better. It does not eliminate future busts, but that is a good thing. For capitalism to survive and thrive it needs to allow creative destruction, where some firms go bankrupt and other firms replace them. Bailouts are not part of this equation. Companies like AIG and Lehman brothers should not have survived intact. Allowing time to sell off their pieces would manage the systemic risk better than bailing them out. If I had bought a credit default swap on AIG, would it have paid off? Why do lawyers have to become involved in these types of cases? If a firm can't survive without government support, this should define a default.

A regulatory council has been added to review systemic risk across the financial spectrum. This group is headed by Treasury and will be subject to political pressure. I would argue that this is why the SEC has been ineffective in the past. It also will feed on the herd mentality prevalent in Washington. A better solution would be for the nation to create an independent Chief Risk Officer similar to the GAO that reviews independently various legislative proposals. The nation's CRO would look at existing risks but especially at emerging risks that could create systemic risk. It would be useful for this group to have offices in several parts of the country to hear varying views of risk. This is the model used by the Federal Reserve Banks.

Accountability

Some firms give absolute accountability to managers, saying that they can do what they want and either succeed or fail. When the product line is widgets this can make some sense, although at least some oversight is always useful. When the product has a long time horizon like financial services or creates a safety hazard like a nuclear plant it is much more dangerous. The perpetrator can be fired but the damage may have already been done.

Outsourced decision making

During the recent financial crisis it was clear some companies had over-relied on models. If the model told them a risk was priced correctly then this became a fact that could not be challenged. Much like rating agency pronouncements were not challenged, whatever the model reported was treated as Gospel. The numbers took on a life of their own, often used in ways the modeler had not intended. Common sense and skepticism were not encouraged and decision making was outsourced to the model. This is nuts! A model should only be used if its shortcomings are understood. Sensitivity testing of assumptions is a requirement, not something that should be done if there is time. The more complex

the model the more appropriate it is for peer reviewers to be engaged, and sometimes for multiple peer reviewers to be used.

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