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BOOK REVIEW

Why the financial crisis occurred

Proposals and recommendations on how to avoid meltdown in future

By Samuel Riding

A publication of SimCorp Strategy Lab, a Danish private research institution led by Ingo Walter, *Understanding the Financial Crisis: Investment, Risk and Governance* should provide plenty of ammunition for asset management practitioners as they embark, or continue, in their career.

Through 11 short essays, the book explores the financial crisis and examines what changes can be made to ameliorate the damage done by the next failure.

First the negatives:

There is a lack of flow between sections – with at least three explanations of how mortgage pools were securitised, for example – and the two chapters on IT/enterprise architecture are only likely to be of interest to top-level management in a position to spend company budget.

The books main strength is the quality of its contributors, including Ole Risager, a former senior economist to the International Monetary Fund (IMF), and David Lando, who has held visiting positions at Princeton University and the Federal Reserve Board in Washington.

A special mention should also go to the comprehensive list of references at the end of each chapter, which are likely to be a useful jump-off point to more fully explore some of the issues raised.

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The first essay is an overview of the macroeconomic build-up to the financial crisis by Mr. Risager, who reminds us that the IMF has predicted the crisis will cause more than US$2.71 trillion in write-down's in the US financial sector, yet to date less than half of this has been realised. This sets the tone, and rightly suggests that despite governments across the world successfully rescuing the financial sector, the legacy of the credit crunch will be with us for some time to come.

He also mentions the geopolitical battle that preceded the crisis, with the US failing to reduce consumption expansion and China failing to appreciate its currency.

The second chapter, which opens a section of the book covering risk and risk management, is a pertinent examination by Caspar Rose, a professor at Copenhagen Business School, of how existing regulation and risk modelling failed to avert the financial crisis.

He reminds readers of the Societe General scandal in which a trader lost US$7 billion on "elaborate, fictitious transactions". This is an extraordinary quote, and Mr. Rose misses an opportunity to explain just how a trader could possibly lose money on something that did not exist.

Nevertheless, he outlines the failure of regulation in detail, and concludes with a list of goals that new regulation should pursue, closing the chapter with a crucial question: Should the government always pick up the pieces even if it creates a moral hazard problem?

The third essay, *The Credit Crisis of 2007* and Its Implications for Risk Management by financial engineering guru John Hull, professor of derivatives and risk management at the University of Toronto's School of Management, is founded upon an examination of asset backed securities created from mortgage pools.

As mentioned, there is more than one exposition of the kind of engineering that many argue lie at the root of the financial crisis, but Mr. Hull's is the only one readers need.

A key point – that collateralisation should be an essential component over-the-counter derivatives trading – is well made, but Mr. Rose is in an enviable position of being the first contributor to broach the subject of compensation schemes, and gives it only three paragraphs.

This is something of a missed opportunity, given no-one has yet spoken to the industry and urged it to re-

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evaluate compensation in a manner that justifies the interests of shareholders and justly recognises the excellence of staff. So far, regulators have merely focussed on the amount of compensation, not the nature in which it is calculated.

In his *Thoughts on the Role of Mathematical Models in Light of the Crisis*, Mr. Lando, head of the department of finance at Copenhagen Business School, examines the precursors to the 2007 crisis.

He looks at the "correlation crisis" of May 2005 triggered by downgrades to US automakers Ford and GM, arguing that this was a warning that the models in place for judging collateralised debt obligations did not work.

Premium correlations between the non-equity tranches of CDOs, he points out, remained largely the same for almost two years before they began to diverge sharply in mid-2007 and sow the seeds of the current crisis, and Mr. Lando says "sharp questions" will now have to be asked about systemic risks in financial products.

"One should not be intimidated by models," he concludes. "If a quant or a risk manager cannot explain a model in simple terms, it is often a problem with the quant. Management boards need enough training…that they know when the problem is truly a communication problem on the part of the modeller."

The second section of the book begins with a general overview by Steen Thomsen, who manages SimCorp's strategic research team, but really gets going in the second essay, in which Jean Dermine, professor of banking and finance at the INSEAD business school in France, argues the premise that the current reform agenda in the financial sector is incomplete.

He cites three areas, namely the lack of accountability of banking supervisors, the "too big to fail" doctrine and the supervision of international banking groups in our cross-border financial world as major issues, and provides several worthwhile insights.

> *"An essay on reputational risk by Ingo Walter, director of SimCorp's StrategyLab, includes a fascinating section on how financial institutions can value this and quantify its impact on share prices"*

Arguably the most pertinent is his argument that the disappearance of major financial institutions in the crisis has created even larger, cross-border financial institutions that can no longer be regulated in a home-country context alone.

An essay on reputational risk by Ingo Walter, director of SimCorp's StrategyLab, includes a fascinating section on how financial institutions can value this and quantify its impact on share prices.

Awareness of reputational risk appears to have been sorely lacking in the build-up to the financial crisis, particularly in mortgage lending, and Mr. Walter provides two useful case studies: the takeover of Banesto by Bank of Spain in 1993 and its impact on major shareholder JP Morgan & Co's reputation, and Citigroup's multi-faceted involvement with the 2002 Worldcom bankruptcy, before reaching his conclusion.

In the book's ninth chapter, Renee Adams, research associate at the European Corporate Governance Institute, tackles a burning question: Should boards of financial firms be blamed for the financial crisis?

The chapter's highlights are two comprehensive analyses. One of the governance structures of banks versus non-financial companies and another comparing non-bank financial to non-financial firms.

Using a series of metrics, she concludes that banks and other financial firms do not necessarily have worse governance than non-financial sector companies. Although there is a sense that she ignores the elephant in the room – that financial companies have the capacity to infect all business sectors while non-financial firms tend to stand or fall alone, Ms. Adams provides some essential insights.

The last chapter in the regulation and governance section is the second examination of IT systems, and is by some way the longest chapter in the book. It pretty much confirms the stereotype of IT practitioners by being rather dull, and the author's conclusion that "a solid Enterprise Data Management platform is key in any modern financial institutions" is insipid.

In the coda of *Understanding the Financial Crisis: Investment, Risk and Governance*, Caspar Rose interviews three senior figures in the asset management industry: Tom Wilson, chief risk officer at Allianz SE; Hugo Banziger, CRO at Deutsche Bank; and Lars Rohlde, chief executive officer of Denmark's state pension fund.

This is a fitting end to SimCorp's essential study of the financial crisis and its aftermath, not least in how the three interviewees stress that what can be seen as a tragedy should now be recognised as an opportunity. ■

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