



the doom loop in
the financial sector
and other black holes of risk

William Leiss

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Preface

Note to the Reader:

The following text differs slightly in detail from the copy-edited version that appears in the published book.

The caretakers at the Grand Library of Baghdad, which was the unsurpassed glory of the civilized world in the thirteenth century, might be forgiven for not having anticipated the day in 1258CE when a passel of rude horsemen originating in far-off Mongolia would consign their entire collection to the waters of the Tigris River, which it is said ran black from the ink leached out of thousands of precious manuscripts. And even very much later, in the nineteen-twenties, it is understandable that most German Jews, proud citizens of a cultured land justly renowned for its dominant position in humanity's bold new science, atomic physics, would have had no inkling of the catastrophe awaiting them from the resurgence of barbarism in their homeland a mere decade later.

We are so much wiser and better-informed now. True, there is still in our behaviour much fodder for commentators to chew on, especially when it comes to our

inability to do simple risk-risk comparisons (Gardner 2008). A favourite example is the temporary shunning of air travel after the events of September 11, 2001: Risk experts gleefully did the easy calculation to estimate the excess fatalities per passenger-mile faced by those who chose to drive their cars rather than to fly for long-distance trips.

Admittedly many small tragedies are scattered across populations when individuals stubbornly prefer some obscure fad to good evidence and expert opinion: Parents who are determined to believe that vaccinations cause autism, for example, endanger and sometimes unwittingly kill their children out of a perverse excess of concern for their well-being (McNeil 2009). There are still too many episodes of such idiocy, but one should also keep in mind that on the whole modern societies have come a long way, in a relatively short time, from a past during which seeking “professional” medical attention for any ailment greatly increased one’s risk of additional misery and death.

Those who take delight in cataloging the public’s egregious failures in handling risks sensibly almost always overlook the equally-obvious, and far more consequential, mistakes made by industry and big governments, which arguably have fewer excuses for their persistent mismanagement of risk. There is a real danger in focusing too much attention on small personal and family tragedies resulting from the difficulties ordinary folk have in making sensible decisions under conditions of uncertainty. The danger is that in doing so we neglect a far more damaging tendency in our society, namely, an urge to make huge and extremely risky bets by those who should know better. This is a curse that afflicts the most powerful economic and political elites on the planet, who among other things have recently packaged their national economies into a set of exotic black boxes and were using them as collateral at the casinos.

The collapse of the hedge fund Long-Term Capital Management (LTCM) in September 1998, which threatened the liquidity of global financial markets and prompted an urgent rescue mission by the U. S. Federal Reserve, prefigured in miniature the colossal financial crisis which exploded a decade later. One would have expected the LTCM episode to have served as a warning against the madness of infinite leverage and a faith in the mathematical modeling of risk for derivatives, and to have reinforced the need for close regulation of the banking sector as a necessary cure for excessive risk-taking. To the contrary, under Bush the Son the deregulatory mania was given free rein, and the captains of capital used LTCM and Enron as models for refashioning the entire financial sector into a colossal Ponzi scheme, the unraveling of which may be still only in its early stages.

It is as if collectively we have been deceived by our presumed sophistication with the tools of risk management (Nocera 2009). More precisely, we allowed the financial elite to abuse their limited facility with statistical manipulation in order to disguise a level of imprudent risk-taking so monumental in scope that, as of now, no one knows where the ultimate limit of the downside risk may be. Like the hapless librarians of medieval Baghdad, the citizens of contemporary nations ranging in size from Iceland to China had no inkling of what calamities were about to strike.

Equally clueless, apparently, were the “masters of the universe,” the chieftains of the great investment and commercial banks who ran the casino. This becomes apparent in a long and richly-detailed *New Yorker* article published in September 2009 on the anniversary of the failure of Lehman Brothers (Stewart 2009). Over a period of three days – Friday to Sunday, September 12-14, 2008 – the CEOs of all the major Wall Street

investment banks and the two largest commercial banks in the United States, plus three foreign banking giants (Barclays, Credit Suisse, Deutsche Bank), about a dozen firms in all, representing a hefty segment of the world banking system, were called to a series of emergency meetings at the offices of the Federal Reserve Bank of New York by Henry Paulson, then U. S. Treasury Secretary, and Timothy Geithner, then president of the New York Fed. The program on that weekend was to design a solution for the imminent collapse of Lehman Brothers and the threat that Merrill Lynch, and then others, would soon follow. Among those present were a few who had looked at Lehman's books and concluded that the firm was beyond saving; one of them was Christopher Flowers, head of a private-equity firm and a specialist in rescuing failing banks. This exchange took place as the Friday-night meeting was breaking up:

When Flowers was leaving, he turned to Paulson. "By the way," he said. "Have you been watching A.I.G.?" "Why, what's wrong at A.I.G.?"

Paulson asked.

Ben Bernanke, chairman of the U. S. Federal Reserve, remarked sometime later that "there was a significant risk that A.I.G.'s failure could have sparked a global banking panic. If that had happened, it was not at all clear that we would have been able to stop the bleeding, given the resources and authorities we had available at that time."¹ On the following Tuesday, September 16, the U. S. government put \$85 billion of public money into AIG (American International Group), which turned out to be a down payment. Only

¹ Quotations are from Stewart 2009, pp. 65, 71; the longer account by Andrew Ross Sorkin (2009) is cited in Chapter II, Section A, where there is further discussion of the AIG bailout. It is possible that Paulson was dissembling, in his reply to Flowers, not wanting to reveal what he knew or suspected at that point in time. But, as shown in the detailed accounts in Sorkin 2009 and Lowenstein 2010 (chapter 14), Geithner and Bernanke were so preoccupied with Lehman's imminent failure that they didn't turn their attention to the far more serious case of AIG until, literally, two days before that firm would have had to file for bankruptcy.

a few of the most senior government officials and the CEOs of some of the largest commercial and investment banks in the world, who were present at those crisis meetings, had realized that the global financial system was on the brink of complete collapse.

This is what is new in our situation today: Risk management has been recruited into the service of a grand game, to be manipulated by economic and political elites who make larger and larger bets on future outcomes for short-term advantage. Citizens are easily dazzled by the interim gains in which they are allowed to share, and are thus blind to the reality that every bet entails exactly the same remorseless logic: The scale of the potential downside loss increases in proportion to that of the potential upside gain. Of course, every bettor thinks that losses can be recouped in the new day. None of them wants to face the possibility that bets made collectively by many nations tightly interlocked in global markets may not be at all different in kind from those made by the individual gamblers who cannot stop until bankruptcy intervenes. As the families of those unfortunates know all too well, there are some types of ruination from which recovery is impossible, ever.

The long account of this crisis in Chapter II seeks to support the proposition that still today there is no adequate risk management framework in place for the world's banking and financial sector. The causes of that catastrophe have not been addressed, because the worst-affected nations (the United States and the European Union) cannot agree on what the key risk factors are and, therefore, cannot agree on the measures needed to mitigate the risk of experiencing another round of the same. Most politicians there hear only the siren-song emanating from the industry titans in the banking sector, a calming lullaby about how what happened was a statistically anomalous "event" so

remotely improbable that no rational being could possibly have foreseen it: Since no one could be held responsible for such randomness, it follows that there are no guilty parties, and thus no institutional change – especially not a much tighter regulatory regime – is warranted. And why wouldn't the bankers enjoy playing with matches again, when they thrive under a system of moral hazard in which obscene profits are privately appropriated while catastrophic losses are socialized and borne by the taxpayers?

Blithe indifference to the inherent limitations of risk management, an orientation arising in the rapaciousness of the already-fortunate, is thus the proximate cause of the current financial meltdown. It exists alongside its diametrical opposite, an irrational resistance to the need for precaution in areas of decision-making where the unique strengths in the risk management approach have been deployed well. Nothing illustrates this countervailing tendency better than the world's reaction to the risk of climate change, which amounts to a gigantic wager that we need not take this risk seriously unless and until it can be demonstrated that any risk mitigation we undertake won't act as a brake on steady GDP growth for any nation on the planet.

The recommendation to avoid “dangerous anthropogenic interference with the climate system” was agreed to in the United Nations Framework Convention on Climate Change in 1992 and ultimately ratified by 192 countries. Capping total global greenhouse gas emissions as soon as possible, then slowly ratcheting them down again, is currently the only available risk control measure.² The world's response was straightforward: Emissions have risen steadily since that time, and for certain large actors have done so at an accelerating rate. At least the developing world, notably India and China, has a reasonable excuse – rapid economic growth is now regarded as a necessity, not a luxury,

² Ramanathan and Feng 2008, Schellnhuber 2008, Solomon et al. 2008.

for them. Opposition to the Kyoto Protocol in the developed world, led for a long time by the United States and Australia (with some more recent help from Canada), was accompanied by a well-orchestrated attack against the findings of published, peer-reviewed climate science.

Some otherwise seemingly intelligent persons have been whispering about a “hoax” perpetrated by climate scientists; little do the whisperers realize that the joke (such as it may be) is on them, because if climate science is a hoax, so too is the entirety of modern science, for the former shares the latter’s methodological protocols. There is a delicious irony contained in the apparent paradox here: For if, however unlikely the prospect, the current scientific consensus on climate change turns out to be very wrong, rather than being in need of constant refinement (the normal case), this fact will be discovered and confirmed by the same scientists, using the same methods, who are responsible for the current consensus.³

These twin expressions of a misunderstanding of risk management by those at the helm of the most powerful economic and political institutions – a lack of appreciation of its strengths as well as its limitations – define in great part the character of our age and its future.

³ The low probability of the contrary case (that the current consensus is very wrong) dictates the sensible policy choice, which is to begin implementing the risk control measures now – as opposed to promising to begin implementing them sometime in the future – in view of the length of time that will be required to complete the process. In addition, there are entirely separate policy considerations, namely, the strong case for internalizing externalities across all forms of energy supply, which support the same policy choice.