CHEAP MONEY ISN'T THE PROBLEM, CHEAP RISK MANAGEMENT IS ...

If you listen to some commentators, the root cause of the present subprime-triggered credit crunch is 'cheap money'. The US authorities allowed interest rates to stay too low, too long, and this meant that lenders were able to lend too much to borrowers who should not have been given credit at all. To make matters worse, investors searching for high yield in this low interest rate environment were happy to buy the securities that funded bank largesse without asking too many questions.

It's a tempting argument for bankers, not least because it puts a lot of the blame on the central authorities and greedy investors (aided and abetted by hapless rating agencies). Unfortunately, it obscures the more fundamental reason things have gone wrong and the way to avoid problems in the future.

The problem with the 'cheap money' theory is that it downplays the role of the credit spread (risk compensation), credit risk mitigants (such as loan structure and terms) and underwriting standards.

Credit spreads, mitigants and underwriting sanity should not automatically disappear when the prevailing interest rate is low. Ideally, they shouldn't have much to do with interest rates at all.

They should depend on the risk of the borrower, and, to a lesser degree, on portfolio concentrations in particular lenders.

Importantly, they should depend not just on the losses expected from a borrower over a short period of time, but also on the whole-cycle unexpected loss level and any uncertainties associated with measuring this.

SO WHY DIDN'T THEY?

This begs a question. Why did credit spreads and underwriting standards decline in the low interest rate environment of the last few years, before spiking upwards again recently?

The reason is linked to a fundamental truth in credit industries - it is easy to bring revenue forward and push risk costs, especially unexpected and uncertain risk costs, into the future.

Yet the real economic value of a banker's work depends on tying today's originations to accurate forecasts of expected loss and unexpected loss levels, plus some measure of the uncertainty associated with these calculations.

This tendency is fueled by the way lending industries incentivize their decision makers based on lending volume and current revenue, rather than the creation of risk-adjusted economic value. Even those bankers with compensation schemes adjusted for credit quality tend to be charged for risk in terms of actual loan performance.

The fundamental 'problem' with low interest rates is not that poor people can borrow more or that companies can become more leveraged but that, given poorly structured incentivization, liquidity stimulates indiscriminate lending growth. Soon a banking boomtown is under way that actively promotes and rewards undisciplined risk management, as competitors desperate to meet short term targets build market share with the raw material of lending - cheap funds - while ignoring the true 'added value' of banking - credit differentiation.

The low interest rates and the subsequent high borrowing volumes of recent years were therefore important, but only because they helped induce this fierce, indiscriminate, competition for market share and the corrupting mechanisms that flooded in to support it (e.g., poorly controlled broker origination).
To be sure, new securitization techniques exacerbated the problem by allowing originators to pass subprime assets of uncertain value to overkeen investors further down the line. We need to be careful of this as a full 'explanation' however. Historically, across many lending markets, originators have lent

out bank money at an uneconomic market price even though most of the risk has remained on their own institution's balance sheet. Bringing everyone under the same roof may not be sufficient as a solution.

Is this subtle distinction between the 'cheap money' argument and the 'boomtown' argument important? Yes, in terms of the fundamental remedy. The remedy is not to hope that borrowing remains expensive or to 'uninvent' securitization, but to embed bottom-up risk-adjusted pricing - the kind that takes account of unexpected losses and uncertainty, not just expected losses - more firmly in each part of the credit chain.

For all the technical talk that has surrounded the present banking crisis, this brings us back to some rather simple questions. For example, why are originators - in banks, and outside them - still so often rewarded in terms of volume, or simple spread, rather than true risk-adjusted value? Why is CEO compensation often still tied to measures such as Return on Equity? Why are bank limit frameworks still so often based on volume and notional limits rather than economic risk?

Our 'boomtown' argument also highlights the implications for bank strategy across many banking sectors. Banks need to monitor and 'see through' banking cycles to the underlying risk-adjusted economics so they can identify the point in the cycle their institution stops making money and starts to lose it, on a risk-adjusted basis.

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WHAT CAN INDIVIDUAL BANKS DO IN A MAD MARKET?

This begs an uncomfortable question. What can a well-run bank do in the face of cyclical market pricing that is determined by short-term boomtown competitors who have no interest in the long-term cost of risk?
For monolines, the cyclicality of the banking business is a real problem. Unlike large universal banks, they really do have a problem in stepping off the dance floor because they have nowhere else to go. For them, cyclicality is part of their business model risk.

But they can dance to a different tune, e.g:

- put money back to shareholders where they cannot earn a decent risk-adjusted return
- cut costs and keep expenses flexible
- use risk-adjusted pricing to identify the least-worst risks in the market
- develop market niches where market pricing is not so fierce
- develop branding and marketing strategies that differentiate the bank

Here we can make an analogy with the airline industry. Airlines fly people places, and that's pretty much all they can do. But in the face of a cyclical over-supply that drives prices below the point at which a firm can make money, does recent history suggest it makes sense for airlines to carry on competing for expanded market share as if business were normal? Or does the airline need to change its business strategy?

Most banks aren't monolines, and for them the implications are less tough. These banks simply need to adjust their flows of capital to their different business lines to reflect the underlying economics of each business.

Yes, it can be politically difficult to step aside from a still-growing market. Then again, each time there is a banking crisis banks prove they can slam the brakes on pretty hard when they want to.

CAN BANKS REALLY MEASURE RISK?

This argument presupposes that banks can measure credit risk and judge the right point in the cycle where the market price dips below the bank's internally-calculated risk-adjusted price.

But can they? In the case of US subprime, surely many banks were trying their hardest to measure the economic cost of risk and to discriminate between subprime borrowers - and the problem was that the industry's models, including rating industry models, did not work?

Well, yes and no - mainly no. Risk modelers in banks and elsewhere were entirely aware that the subprime sector was new and had not suffered the kind of economic shocks that would yield reliable default and risk factor correlation statistics.

If the subprime industry had behaved in a way that was sensitive to credit risk we would therefore have seen a number of features in the run up to the crisis:

- strong control over origination and due diligence, so that at least the basics of risk measurement were solid;
- acknowledgement of the inevitable uncertainty in subprime risk modeling in this cycle, and the relationship between this and funding risk
- emphasis on business line diversification to absorb any shocks arising from uncertainty
- product structures that upfronted credit risks rather than temporarily obscuring them

In fact, we did not see much of this. To the contrary, brokers were disproportionately likely to originate subprime; credit risk data was poorly collected and attached to complex securitized risks and structures; diversification was patchy; and many subprime borrowers were offered teaser rates followed by sudden rate hikes.

Meanwhile, the poor quality of the fundamental risk information attached to the bundles of loans underlying securitizations is one reason investors panicked, looked for reassurance that could not be given, and turned a credit crunch into a banking industry liquidity crisis.

CONCLUSION: WHAT DOES THIS MEAN FOR OTHER BANKING MARKETS?

There are lots of 'explanations' for the credit crunch of summer 2007, and many are useful to some extent. But they shouldn't distract us from the main lesson to be learned, which is one the banking industry seems to have to learn again and again.

Banking is an industry where it is easy to bring revenues upfront and push risk costs into the longer term. Well-run institutions put in place a series of cultural and technological systems that counterbalance this tendency.

For example, they focus on whole-cycle risk, compare bottom-up risk valuations to market valuations, make explicit and manage any uncertainties associated with risk measurement, tie this information securely to the ongoing loan, and make sure it informs compensation and investment decisions.

Where it is difficult to push risk-adjusted compensation and performance measurement down to line level, such banks use robust risk-adjusted limit frameworks and top-down business line performance measures to offset some of the bad effects of volume-based incentivization.

They also recognize that many banking markets are cyclical and adapt their strategies accordingly.

This may not sound like rocket science, but it is a lesson that banks can take out of the subprime market and apply to many other banking markets over the coming months, before the talk of recession becomes even stronger.

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