Crisis Analysis: Views from a Non-Risk Manager

To understand their true exposure to risk, firms must rely less on mathematical models and pay more attention to the unpredictable human element.

By Michael J. Panzner

I am not a risk manager. Moreover, I am not an economist, nor an underwriter, nor the head of a business that regularly engages in risky transactions. Under the circumstances, many people might naturally assume that I am not qualified to advise risk professionals on how to do a better job managing their firm’s exposure.

Maybe they are right. But then again, as a long-time trader and student of markets, history and human psychology, I believe that sort of perspective might explain why so many individuals — including risk managers — were caught off-guard by the biggest financial crisis since the Great Depression.

To be sure, there are plenty of reasons why the financial world, as well as the real economy, was poised to come undone as 2007 unfolded. One major factor, however, was the large number of ill-founded and unquestioned assumptions that managers, policymakers, regulators and others had made — and relied upon — up until that point.

The assumptions came in many shapes and sizes. At the broadest level, there was a widespread belief that, despite mounting evidence that financial institutions around the world were engaging in increasingly dangerous behavior — including operating with ultra-slim margins of error and unprecedented leverage — there was little reason for alarm.

People assumed that the Federal Reserve would step in and prevent things from getting out of hand if anything untoward happened, which cynics had long ago referred to as the “Greenspan put.” Many also believed that Wall Street’s increasing sophistication and the lessons of history meant we had more control over our economic destiny than our predecessors did. According to the conventional wisdom of the time, the business cycle was more-or-less dead, financial crises were history, and the good times could, in theory, go on forever.

This sense of overconfidence — hubris, really — also rested on other dubious assumptions. With Wall Street reaping big rewards from market-related activities, including securitization and proprietary trading, it wasn’t surprising that many insiders placed great faith in the power of markets to help them in other ways if need be. Of course, if they had studied the past, they would have known that the liquidity they were counting on could readily disappear.

In fact, if recent developments have taught us anything, it is that those who are charged with managing risk need to have an exceptionally strong grasp of history, especially economic and financial history. Not just of the period that began at the start of the last bull market, or at the end of World War II, but of the span that extends, say, to the early days of the 17th
century tulip mania.

As we’ve witnessed on countless occasions, “this time is different” is only true if you don’t go back far enough.

**Dangers of a Quant-Heavy Approach**

Another reason why risk management did not in many cases achieve the desired results — that is, protecting firms from getting into serious trouble — stemmed from the strategies and tools that many depended on. In the years leading up to 2007 (as well as today), powerful technology and rocket-science analytics imbued the industry and those who regulate it with a false sense of confidence.

Although a tightly-structured, data-driven methodology seems like the best way — and to some, the only way — of generating an unbiased assessment of where things stand, it has serious shortcomings. Among other things, this approach fails to take account of the dark forces that come into play when risk management matters most — i.e., when the hurricane strikes.

Moreover, as is true with all attempts to quantify human behavior, real life tends to be more complicated than any model can handle. The upshot: such systems invariably incorporate guesswork and shortcuts. And yet, once the data goes through the mathematical meat-grinder, it assumes an air of infallible precision that is difficult to challenge, even with good old common sense and the wisdom of hard-knocks experience.

It is easy to lose sight of the bigger picture when the focus is on “the numbers.” A case in point: the curious notion that pyramidizing risk exposure is somehow less dangerous when market volatility is decreasing, as some value-at-risk models would have us believe. Huh? Anybody who knows anything at all about real-world dynamics would challenge that assumption.

In fact, the proliferation of quantitatively-oriented methods of analyzing man-made activities brings to mind what I believe was another contributor to the crisis: an overreliance on systems and technology. When risk management is viewed as science, where complex algorithms, a hierarchy of rules, and textbook training dictate the best course of action, it’s pretty clear that insufficient allowance is being made for the human element.

**Unpredictable Humans**

This is not to say that all risk models are riddled with bad math or incomplete histories, or depend on inputs that are unproven or irrelevant to the situation at hand, as was all too often the case in the lead-up to the crisis. But even when the methodology has been carefully designed and each aspect dutifully tested, the fact is that mechanized approaches fail to account for what behavioral economists long ago figured out.

People are, more often than not, irrational and unpredictable, and they make decisions that may or may not be to the advantage of themselves or others, including the firms they work for and society at large. Sometimes, the drivers will be economic incentives. At other times, the impetus to act will be the pull of the crowd. That means the true level of exposure might be far different than the theoretical value.

Can a data-driven approach take all of this into account? In a word, no. Hence, those who are tasked with managing risk need to learn as much as they can about the biggest creators (and abusers) of risk: people. They must spend time studying human psychology and understanding just how people think, interact with others and respond under pressure, especially when they are exposed to financial risk in one form or another.

**Parting Thoughts**

One final key mistake that many risk managers made — both before and after the crisis erupted — was to direct the bulk of their attentions to the idiosyncratic exposure of the firms they worked for. As the crisis spread, what seemed to cause the most damage was not the fallout from the bad positions of any one operator, but the threat posed by the collective exposure of many different market participants.

Realistically speaking, the notion that an insular department or firm-centric approach can adequately measure just how exposed a business is to loss or ruin in a highly competitive, tightly-interconnected and increasingly complex world leaves much to be desired.

Although some firms might genuinely have believed they had matters under control when viewed in a relatively narrow context, it was often an illusion. In many cases, it was like putting out a fire in the yard as a blaze raged in the forest next door.

In the end, then, if there is one key takeaway from the events of the past several years, it is the idea that those who are charged with evaluating and managing risk exposure need to question each and every assumption. Among those they might want to begin with: Are traditional approaches to risk management the best way forward?

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