COMMENT

Advantage, bankers

Robert Jenkins, an advocate of greater curbs on leverage, doubts that the lessons of the banking crisis have been learned

It was six years ago that Bear Stearns stumbled. Others soon followed. Cyprus is but the latest chapter in this saga. The devastation has been educational. So what have we learned? What should we have learned?

At least three things: banks misjudge risk; regulators misjudge the risk-taking acumen of banks; and banks' capital funding is insufficient to absorb the consequences of such mistakes.

A few facts will illustrate. The kick-off to the crisis occurred in July 2007. Two investment funds structured by Bear Stearns collapsed. Ironically, in the very same month, a not dissimilar vehicle called Carlyle Capital Corporation was listed on the Amsterdam Stock Exchange. The Bear Stearns funds deployed gearing of six to 10 times. Not to be outdone, Carlyle Capital Corporation achieved leverage of 33 times – before it imploded. This means that for every dollar of investor equity, the Carlyle Capital manager bought 33 dollars of securities. How? Easy: for every dollar of client capital it added 32 dollars of debt. With that degree of leverage, it takes a mere 3 per cent decline in asset values to wipe out 100 per cent of investor equity. Asset values duly declined. Investors were duly wiped out.

'Tough, onerous and stifling' rules? What would you call them?

Not long after the demise of such vehicles, banks themselves began to fail. Why? Because, for every dollar of shareholder-supplied equity or "capital," many banks had borrowed 32 dollars or more of debt. They then used the one dollar of equity and 32 dollars of debt to acquire and fund 33 dollars or more of loans, derivatives and structured securities. Some institutions went well beyond 33 times leverage. A few percentage point declines in asset values were sufficient to take them down.

Of course, that was then and this is now. We have all learned our lessons – right? Well, you be the judge. The first lesson should have been that bankers misjudge risk. Bank management, bank boards and bank shareholders now prevent reckless risk-taking – right?

Alas, neither highly paid talent nor sophisticated trading models has banished greed or stupidity. Thus JPMorgan, widely respected as the best risk manager in the risk-management business, got it wrong to the tune of $6bn dollars – a full five years after the financial fiasco. Now, JPM's CEO is widely considered to be the best banker in the land. Nevertheless, he apparently did not know what was going on under his nose. His hand-picked lieutenant, who headed the "Investment Office" – locus of the loss – was considered to be the finest in her field. She says she did not know what was going on under her nose. JPM's risk management systems are widely considered to be state of the art. Indeed. Such, then, is the state of the state of the risk management art.

The second lesson was that regulators misjudge the ability of banks to judge risk. No doubt they are now up to the task – right? Perhaps. But it was only last October that the European Banking Authority completed stress tests on European banks. Did it spot the troubles in Cyprus? Did it act to prevent them?

The third and most important lesson was that there was too little capital to absorb even a small percentage decline in the value of bank assets. When those losses hit, debt funding fled. Some institutions became insolvent; many more became illiquid. Bail-outs, credit crunch and economic decline ensued.

But at least the pain was not in vain – right? Obviously, our political leaders have ensured that this will never happen again. Well, er – not exactly. Those leaders supported by those regulators gathered in a place called Basel and hammered out new rules. From 2019, banks will have to ensure capital funding equal to 3 per cent of their assets. In other words, banks will be able to borrow "only" 32 dollars for every 33 dollars of assets they hold.

Yes, you read correctly: one dollar of loss absorbing equity capital will stand between the bank and the taxpayer should there be a fraction of a loss on every 33 dollars of risk taking. It's Bear Stearns and Carlyle Capital Corporation writ large. Many bankers call these new regulations "tough, onerous and stifling". What would you call them? How can this be? You may well ask. Please do. Call your congressman or MP.

The troubles first surfaced six years ago. The new rules to address them take full effect six years from now. It is half-time at the Banker Bowl. As the cheer leaders of finance take to the field the scoreboard appears to read: banking lobby 21, public 7.

But let us be optimistic. The game is not over.

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