Black swans’ seem to be on the minds of many in the financial world. If you have been tracking the recent turbulence in finance – the mortgage mess that is causing some homeowners to lose their house and others to be unable to buy one, the major banks skating on the thin ice of shallow liquid assets, and the numerous depressing news reports of economic slowdowns or recessions – then you have probably also encountered references to black swans.

Black swans certainly exist, though you’ve probably never seen one, cautions Nassim Taleb; and they gave rise to the title for his recent top-selling book, *The Black Swan: The Impact of the Highly Improbable* (Penguin 2008). In it, former financial trader Taleb highlights the lack of understanding of events that, though perceived as statistically rare and extreme in occurrence, arise with unexpected frequency and impact. Some might be tempted to see recent events in the financial markets as just such black swans.

Recent losses and failures must challenge us to ask why losses on an unprecedented scale have occurred.

But this would be quite wrong, in our view. Many of the flaws that have led to current turbulent conditions have not ridden in on the back of a black swan. Instead, they are the result of weaknesses and failings in the interpretation of risk analysis and the processes of oversight. Have markets conveniently forgotten similar outcomes of the last 10 years?

Consider the 1998 bailout of Long Term Capital Management, orchestrated (though not funded) by the Federal Reserve Bank of New York after the company suffered losses of more than $4 billion in less than four months. Lessons that should be apparent here include an unexpected breakdown of historic correlations, modelling risk, inadequate stress testing, a lack of transparency and disclosure, and generous extensions of credit. All this has an all-too-familiar sound.

So who, then, is at fault? Is there enough oversight? Is management sufficiently accountable, and is the governance framework actually best practice?
effective? Can the solution be greater financial regulation? Before answering these points, let us first examine the regulatory background.

Regulations and risks
For many financial services organizations, including banks, building societies, investment firms and asset managers, 2008 represents the first full year of applying the new, global Basel II regime.

Monitored and enforced by the Financial Services Authority (FSA) in the UK, this sets standards for the minimum amount of capital required for any given level of risk or exposure. It is intended to align required capital more closely to risk than its predecessor. Basel II also encourages market discipline through a set of disclosure requirements allowing stakeholders to assess key data on a firm’s capital, risk exposures and assessment processes.

An important element is the promotion of a forward-looking approach to capital management and supervision. Recent losses and failures must challenge us to ask why losses on an unprecedented scale have occurred, given the huge sums invested to support Basel II compliance. Notable among current analyses is the frequent use of the word turmoil, defined by my dictionary as “a state or condition of extreme confusion, agitation or commotion”. Surely this is not something we expect from our leading financial services providers, but it is certainly something felt by Northern Rock shareholders and depositors.

Markets and product innovation will always run ahead of regulation. However, many of the largest and most sophisticated organizations have shown an insufficiently robust view of the future and subsequent risks. How quickly we forget the lessons learned from past mistakes. So, what is needed to avoid such mistakes in the future?

Last year’s financial chaos launched a plethora of initiatives from the great and the good. Just as the financial scandals in the early years of the decade begat the US Sarbanes-Oxley legislation (SOX), so the recent market turmoil has initiated many analyses and reports. These are all intended to identify causes and to recommend solutions and actions; they include contributions from the Basel Committee on Banking Supervision, Senior Supervisors Group (the financial services regulators of the UK, US, France, Germany and Switzerland), International Organization of Securities Commissions, Joint Forum (of bank, insurance and securities supervisors from 13 leading economies), Committee on the Global Financial System (a G10 central bank forum), President’s Working Group on Financial Markets, International Monetary Fund, Bank for International Settlements (BIS) and the Financial Stability Forum.

It is encouraging to note the consensus of views and a number of recurring, if somewhat disturbing, themes highlighted, such as the following:

In several respects, Basel II (as implemented) has not addressed the conditions recently experienced.

- The role of credit-structured products and their related risk management. Risk management processes have not stood the test of a rapid change in the market. In particular, stress testing is not yet mature or incorporated in firms’ decision making.
- The origination and distribution model that underpins the mortgage market. This model, through the use of special purpose vehicles, has reduced the transparency of where risk actually lies.
- The debate over the merits of “fair value accounting” introduced by international accounting standards. Problems remain in achieving actual mark-to-market valuation of assets in stress conditions.
- The need for more meaningful and consistent qualitative and quantitative information about risk exposures. Pillar 3 of Basel II already provides a platform for this, but analysis shows that few firms come close to meeting all the best practice disclosures.
- The need to enhance liquidity management practices and supervision and to establish international consistency in supervision and central bank liquidity operations.
- The necessity of improvements to credit rating processes to differentiate the ratings used for structured products from those for corporate bonds. More thorough reviews of data quality and underlying assets are essential.

Taking these comments together, and in answer to the question “Who is at fault?” we can see that it is not only the banks themselves, but also the regulators, standard setters, central banks and credit rating agencies that have been called to account.

So what’s gone wrong, given that banks and investment firms, as stated earlier, have spent the last seven years investing heavily in preparing for and implementing Basel II? Remember, this is a framework supposed to align capital more closely
to risk. The answer is that, in several respects, Basel II (as implemented) has not addressed the conditions recently experienced. Let’s consider, then, what is included and what is excluded.

First, Basel II deals with capital adequacy and not liquidity. Liquidity is the ability to fund increases in assets and meet obligations as they fall due. The Basel Committee had actually established a Working Group on Liquidity at the end of 2006. However, its recommendations, including the need to update and strengthen practices, were only published at the end of 2007 and will not take the form of revised guidance until later in 2008.

Secondly, risk management techniques and processes have been found lacking in predicting and preventing many of the losses that have occurred. In part, this is based on a lengthy period of benign activity in the mortgage markets – sound economies resulting in steady growth in house prices and low levels of arrears and possessions. Statistical projections based on this historical data underestimated the magnitude of the losses that began to appear last summer. If only the statisticians had read and acted upon Taleb’s book, we might have seen a different outcome.

In addition, management in many firms may have been unwilling to consider the results and potential impact that stress testing should have identified. In a speech to the UK Building Societies’ Association Conference, FSA Chief Executive Hector Sants warned that the FSA continues to find unacceptable practices. Firms focus on the additional income predicted for new products without identifying, and pricing into the products, the additional risk and costs that arise.

Thirdly, the Basel Committee has recognized the need to enhance the capital treatment of “complex structured credit products” and other instruments that may be underweight in the current requirements. However, the detail of this has yet to be addressed and will not be fixed overnight.

Does enough oversight exist? If the regulatory process is to succeed, regardless of the level of detailed rules, it is critical that regulators undertake their responsibilities fully and effectively. The Northern Rock case highlights shortcomings in the supervisory review process. Similar issues will be highlighted in other jurisdictions where significant write-offs have arisen. Retaining the quality and numbers of staff needed to deliver this oversight remains a challenge for regulators worldwide.

Given all that has been invested in Sarbanes-Oxley programmes, why did they not prevent such losses?
Where was SOX?
Many of the institutions that have reported significant write-downs are subject to the requirements of the Sarbanes-Oxley Act. These include not only the obvious US-headquartered entities such as Citigroup, Merrill Lynch and Morgan Stanley, but also organizations referred to as “foreign registrants”. These have a US share or debt listing that triggers a SOX compliance requirement; included are UBS, HSBC, Credit Suisse, Deutsche and Dresdner Bank.

Given all that has been invested in SOX programmes, why did they not prevent such losses? Basically, SOX deals with financial reporting and controls in a way that is backward-looking, rather than a broader-based forward-looking approach to risk management. In consequence, although all the SOX boxes may have been ticked and the basic steps and financial controls applied, this does not necessarily provide an assessment of what is to come – trends and future threats. Clearly, further thought is required around integrating the investment in SOX into a wider enterprise risk-management framework.

We have witnessed the departure of a significant number of chief executives following their companies’ declared losses. However, this is somewhat a case of bolting the stable door after the horse is stolen. Management may have become complacent in the face of benign markets and feel that SOX, when combined with Basel II, has delivered a degree of security that is not yet fully embedded. Management must take a more holistic view, examine what has slipped between the cracks, and ensure that a top-down culture of effective control, risk management and governance is maintained.

Driving real change
There is one influential initiative that may drive real change. In October of last year, the G7 ministers and Central Bank Governors asked the Financial Stability Forum (FSF) to undertake an analysis of the causes and weaknesses that produced last year’s market turmoil. The FSF brings together, on a regular basis, national authorities responsible for stability in significant financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. The FSF works very closely with the BIS and seeks to find ways to promote international financial stability, improve the functioning of markets and reduce systemic risk. It was therefore asked to produce recommendations for increasing the resilience of markets and institutions and report to the G7 Ministers and Governors in April 2008.

The resulting report, *Enhancing Market and Institutional Resilience*, highlights the fact that the financial system remains under stress, regardless of actions already taken by national authorities, central banks, regulators and financial institutions aiming to rebuild capital and liquidity cushions. It proposes action in five key areas in which the FSF will facilitate ongoing coordination across global financial markets:

- Strengthen the regulatory oversight of capital, liquidity and risk management
- Enhance processes that will lead to greater transparency and improve valuation techniques
- Change the role and use of credit ratings
- Strengthen the responsiveness of the authorities to risks
- Improve arrangements for dealing with stress in the financial system

The above actions are supported by detailed recommendations targeted at regulators, central banks, international accounting standard setters, institutions, rating agencies and investors.

But these recommendations largely build on and reinforce policies and procedures that are already in effect rather than attempting any radical change. The FSF now faces a significant challenge in gaining commitment and momentum to apply the recommendations. Different countries have been

Treating customers fairly
How is this actually affecting the man in the street? The FSA is in the process of introducing its new “Treating Customers Fairly” regime under which firms must observe and demonstrate compliance with a set of service outcomes for the retail customer. It will monitor closely how retail customers are treated, both as borrowers and lenders, through this difficult period. The UK household saving ratio for 2007 was just 2.9 per cent, compared with 9.5 per cent in 1997, a fall of two-thirds.

Will the very attractive interest rates now on offer from many institutions reverse this trend? More likely, they will lead to existing deposits being moved to higher yielding accounts with the same or a different institution. A low savings ratio is not good news at a time when mortgage lenders are demanding significantly higher levels of deposit from borrowers. For those who already have a mortgage, the statistics are also not encouraging. The number of mortgage possession actions in England and Wales for Q1 2008 was, at 40,442, the highest quarterly figure for more than 10 years and was nearly 17 per cent higher than Q4 2007. Many more customers are starting to believe that they are not being treated fairly.
affected to different degrees by the current turmoil. Europe alone has 27 regulators (some of which are also the central bank) representing its member states. On top of this, Basel II is being implemented at varying speeds in different jurisdictions. Identified weaknesses around valuations and credit rating processes will not be resolved immediately.

**Needed – now!**

More regulation at this time will only deflect focus and resources from what is already known and being worked on. What is needed is a continuing refinement of the principles that have been laid down, learning as much as possible from the events of the last year and applying this to improve the integrity and effectiveness of the processes. This includes improvements in the processes of regulators, who had reviewed and approved the statistical models used by firms in assessing risk.

Institutions, too, must have a more robust forward view of their business and its risks, including more thorough analysis of stress testing and extreme outcomes. Standard setters must work with practitioners to resolve weaknesses in valuation and disclosure processes. Investors need to be more address all these issues in terms of impact on their business and their stakeholders. For those that have suffered significant capital losses, the challenge for the next year is to rebuild stakeholder confidence while maintaining business momentum. The challenge for those with no or minimal losses is to take the opportunity presented to gain significant market share, but to do so in a controlled and managed environment.

To sum up, the evidence to date demonstrates failings in the application, rather than the basic design, of processes of risk, regulation and management. In early 2007, many experts were predicting the likelihood of a major financial shock, though detail on the timing and scale varied widely. What transpired was not so much a black swan as an overfed turkey.

**Resources**

- www.statistics.gov.uk, Office for National Statistics, UK
- www.cml.org.uk/cml/statistics, Council of Mortgage Lenders, UK

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