The financial crisis, drug testing, and monitoring versus management

The financial crisis of 2007-08 has been attributed to causes ranging from abuses of the Community Reinvestment Act (CRA) to irrational exuberance of traders. (Those of us not vested in a particular political position note how the attribution of blame is commonly driven by political motives. No left-wing commentator will implicate the CRA; no right-wing commentator will exculpate it.)

However, it is my view that the seeds of the crisis were planted a generation or more before most of the commonly identified causes, in decisions made in 1984 by the major Wall Street firms – Goldman Sachs, Salomon Bros. (Google them), etc.

Let me switch tracks for a moment. Suppose some national sports body announced that as no athletes had tested positive for performance-enhancing drugs (PEDs) in the previous year, and that as a consequence, they concluded that testing was no longer needed. Aside from the uproar that this would cause, the deficiency of logic is obvious. The absence of positives should be attributed to the presence of testing, and not as an indication of a fundamental change of behavior.

Up until 1984, Wall Street firms involved in repackaging mortgages into mortgage-backed securities (MBSs) had conducted due diligence on the individual mortgages that went into each pool. In 1984, they concluded that as the default rate on these mortgages was so low – the figure of 0.5% was commonly cited – that it made no economic sense to do individual due diligence. Instead, they would look at the pool of mortgages as a whole and have a macro perspective.

Of course, as you relax your due diligence standards, so will borrowers and originators! And now jump forwards 20 or so years… With hindsight it is easy to see that, as in the drug testing example, due diligence acted as a control on adversity, not as evidence for its absence.

Unsurprisingly, this lesson is more widely applicable than just to MBSs and sports. Consider any firm with strong compliance oversight, let us say defined as fully following and enforcing regulations according to strict letter and intent. It is not too difficult to conceive of a few years' problem-free activity followed by the management decision to reduce compliance to meet minimum regulatory standards because with compliance having found no issues, clearly the firm culture is sound and not in need of such oversight. Nor are the subsequent adverse consequences too difficult to conceive of.

One can use another analogy from quantum physics, where as we all know, the observer affects the observation. (Now to be accurate the nature of the effect at a quantum level is not the same as the nature of the effect at classical scales, but the analogy is still good, or at least, effective.) The observer effect is clearly at work here.

The connecting theme here is a confusion between risk management and risk monitoring. When you conduct due diligence (or perform drug tests) you may think that you are monitoring the risk – which implies that you're essentially passively observing what the risk is, if indeed there is any. And you may wrongly conclude that, if your "monitoring" does not reveal any risks, then risk are small. However, you have confused between action and function. The act of conducting due diligence seems like a monitoring exercise. But the function is risk management.

For any risk management system intended to control non-market risks, therefore, you need to be aware of whether you're engaged in monitoring or management and that awareness should be driven by what would happen in all likelihood if you were not so engaged. If the result would simply be a reduction in your own knowledge of the risks, you're involved in monitoring. If the result would be to increase risks previously controlled, you're involved in management.

Does it matter what you call it? The answer is, yes, because the two terms establish the framing and that in turn will tend to affect awareness of the risk. . If you think that you're managing when you are merely monitoring - you will, in all likelihood, eventually suffer a major disaster.

Stephen R. Gould, CEO

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