Bauerle's Bank Notes

Risk Dialectic

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American financial regulators are hell bent on not repeating the experience of 2008. Last week, they trumpeted their widely-anticipated $17 billion settlement with Bank of America over subprime mortgages. Not mentioned was the fact that the sanctioned behavior occurred at institutions like Countrywide FSB *before* BAC bought them. In another show of force, regulators recently rejected as inadequate the "living wills" developed by 11 of the largest U.S. banks as required by the Dodd-Frank Act. Withheld were details of the plans' deficiencies in the regulators' eyes. The rejection of so many banks' plans underscored regulators' resolve.

Under Dodd-Frank, every too-big-to-fail financial institution must adopt, monitor and periodically revise a plan that details how it will liquidate its business in a financial crisis. Less prominent institutions must have contingency funding plans to assure liquidity in a crisis. The plans are the banking equivalent of a family's plan for escaping their single family home if it catches fire (which doors and windows to exit, where to meet afterward). Or a New York City family's plan for how to reunite if the subway doors close when some family members are still standing on the platform (if you are on the train get off at, or if left on the platform get on the next train and go to, the next station on the subway line and meet on the platform there).

The difficulty with living wills for financial institutions is that a financial panic is a whole lot more complicated than a house fire or a subway riding miscue. Inevitably, events behind the crisis are unanticipated, its magnitude is underestimated, or both. This is not to say that bankers and regulators should not plan for potential crises. The central question is what kind of planning should be done. And how much is enough?

My law school contracts professor, Ian Macneil, opined that even the most thoughtful contract planning eventually yields diminishing returns. He cited his own experience drafting a last will and testament for his first clients, a college classmate and his wife. When Macneil asked who should be the fourth alternate beneficiary and the fourth alternate executor, the classmate broke down in tears. To Macneil's "What's wrong?" the client answered, "At that point, I don't care who gets our estate; everybody we care about will be dead."

My long-time partner Lee Keevican owes a measure of his considerable success to legendary Yale football coach Carm Cozza. In an era when Ivy League teams were competitive with Big Ten and similar schools, Cozza taught players that they could only anticipate so much about how a play would unfold. Instead, they needed to work on their reaction times. By responding more quickly to each play as it developed, they improved the team's chances of winning. Cozza's lesson is well understood by traders on Wall Street and the Chicago Mercantile Exchange. "Your first loss is your best loss," goes the traders' saw.

Adapting one's business plan as a financial panic builds is the banking equivalent of statecraft. Success requires continuous observation, assessment, planning and action to reflect the changing dialectic of risk. It eluded Jimmy Cayne at Bear Stearns and Dick Fuld at Lehman Brothers. Both kept to an all-ahead-full mode until the crisis engulfed them. Fed Chairman Bernancke also missed the call. Even after Bear's failure, he proclaimed in April 2008 that market discipline was a sufficient remedy. By September, he and the rest of the nation's economic leadership team, including President Bush and Speaker Pelosi, realized they had misjudged the scale of the problem. So they threw everything they had against it, just in the nick of time. In her remarks at Jackson Hole Friday, Fed Chairwoman Janet Yellin referred to the "extraordinary accommodation" central bankers continue to make by having ballooned the Fed's balance sheet to $4 trillion. Hers is a wonderfully atonal phrase to describe the Fed's unprecedented response to the chaos and fear that gripped markets after Lehman Brothers failed, and in whose shadow we still live.

Congress's desire that banks to have "living wills" is understandable. Yet at a certain point, one must put the pencil down and embrace Professor Macneil's and Coach Cozza's wisdom. Like war games, living wills are useful exercises. What living wills cannot become is banks' and their regulators' Maginot Line. Conflicts are won by combatants who have the skills, the tools and the mettle to adapt their technique in ways that enable them to prevail. That, rather than any pre-crisis plan, is what saved the day in 2008. To contain financial contagion when it erupts, financial market participants must focus on building capacity to adapt to circumstances as they find them, rather than planning to prevent past errors from being repeated.

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