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Financial Meltdown - Crisis of Governance ?

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Remarks by

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Mr Salman Shaikh, Chairman of the Securities and Exchange Commission of Pakistan, Syed Asad Ali Shah, President of ICAP, distinguished delegates from Bangladesh, India and Nepal, ladies and gentlemen, assalamu aleykum.

It is an honour for me to talk to you today, and I thank the ICAP for inviting me.

Hundreds of millions of US dollars and British Pounds have been spent on compliance with Sarbanes Oxley in the US, the Financial Services Act, 1986 in the UK, the Basel regulations and so on. The recent crisis happened despite all these.

Our own SECP has made elaborate Corporate Governance regulations with ICAP's help. Listed companies solemnly report full compliance, even in closely held family companies.

Let me take you back 9 years. The Karachi Stock Exchange was depressed well before the events of 11 September 2001. By 10 Sep 2001, it had fallen by 20% over the previous 12 months. Not much by recent standards, but quite a lot at that time. I was Chairman, State Life Insurance Corporation of Pakistan, and attended meetings in July and August at Islamabad, at which the word "meltdown" was freely used. By 25 Sep 2001, it fell by a further 9%, i.e. a fall of 29% over a little more than 12 months.

So steep market falls have happened in the past. They will happen in the future.

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I submit that "meltdown" is the wrong word. It implies that after "meltdown", everything will go down the tubes. A much more appropriate word is "earthquake". After an earthquake, there is reconstruction, and things climb back to normal. Earthquakes measured on the Richter scale can be severe, or moderate or mild. They will recur, but we don't know when, and we don't know how severe they will be.

Earthquakes happen because of faults in the bowels of the earth. And financial earthquakes happen because of deeply rooted human faults. One is greed. The second is that memory fades, people forget the lessons learnt in the past, and make the same mistakes again.

The impact of the recent financial earthquake on Financial and Capital markets is well known. This ground has been covered by previous speakers. There is no need re-hash this recent history.

Instead I will focus on lessons we should learn and apply, which may Inshallah have a good impact on the future. We should learn how to build earthquake resistant businesses, like people have learnt how to build earthquake resistant buildings.

I will talk about four things: **(1) leverage, (2) management incentive systems, (3) the folly of business models based on high defaults offset by high returns, and (4) the inherent un-insurability of certain risks.**

If I have time, I will say something about the **Efficient Market Theory**.

Leverage

Shareholders' equity is the steel frame that helps the organisation to resist financial earthquakes. Too little means the structure is weak.

Asad Umar's keynote speech yesterday highlighted one aspect common to all the financial institutions that failed: high leverage, a high ratio of liabilities to shareholders' equity.

So we should watch leverage very carefully in future. Risk factors have to be disclosed nowadays. The disclosure is usually done in general terms. Perhaps a specific reference to leverage risk should be introduced. Perhaps the reporting standards prescribed by the accountancy bodies should address this issue. **The ICAP should consider being pioneers in prescribing reporting and audit standards on leverage.**

Management incentive systems

These lay at the root of bad lending decisions taken by banks and other financial institutions. The incentives focussed everybody's eyes on the short term. Hundreds of millions of dollars or pounds or whatever were paid to senior managers as bonuses, to reward them for these bad decisions. Nobody, whether executive or non executive board members, or rating agencies, or

auditors, or regulators, wanted to spoil the party by raising awkward questions. The balloon was self-inflating. Nobody wanted to prick it.

A sound incentive system is extremely hard to design. It requires a thorough understanding of the business, including its financial rhythms. And a thorough understanding of human nature.

I dislike stock options. I won't go into the reasons. It requires a conference by itself. There may be specialised businesses which require incentives linked to share prices. But for most industrial, commercial, service or other businesses, it is probably better to design incentive systems aimed at sound long term growth, based on the parameters of the business itself.

We should be very careful about our incentive systems in future.

Folly of business models based on high defaults offset by high returns

A bank is safe enough if its loans are secured by pledged government securities with little or no market risk, or by Fixed Deposits with the lending bank itself. But how do you measure the default risk, where a bank makes an unsecured loan, or a loan secured by other kinds of assets?

Compared to the mortality risks taken by life insurers, risks taken by bankers scare me.

A mathematical model underlies Basel II. Banks are encouraged to set up their own models. International banks use elaborate rocket-science models to measure and control their risks. But the sub-prime problems of US banks happened despite all this mathematics.

The mathematics mesmerised bankers, and common sense was abandoned. This is faux mathematics, **voodoo mathematics**.

The only solution is conservative lending.

You may say that Pakistani banks have a very small mortgage portfolio, and do not take risks which destroyed large US and UK banks. I beg to differ. Reputable banks advertised their willingness to finance a lavish wedding for your daughter, or a holiday at a mountain resort, or even a designer kurta for Eid.

But should a person incur high interest debt for such luxuries? Is it good for society? Is this banking, or is it money-lending, usury, or *sahu-kari*? Or cynical and immoral profiteering?

A golden rule is: don't sell something that you yourself would not buy. Would these bankers themselves take loans at high interest rates to finance their mountain holidays, or their designer kurtas? Would they pay the enticingly low "minimum payment" on their credit card bills, and incur 3% per month (= 42.5% pa) interest on their balance?

The profitability of such lending depends on high interest, with built in provisions for defaults. Junk bonds were based on the premise that defaults will be off set by high returns. Banks should not fall for the junk bond theory. Do we really want this theory to be embedded in the balance sheets of our banks?

Default rates are not just statistics. Every default is a human tragedy. And I hold the bank or other financial institution responsible for this, because its business model incorporated high default rates and sky high interest rates.

I understand that banks are not quite so enthusiastic about credit card and consumer lending as they were in the past.

About 10 years ago, I wrote to the then Governor of the State Bank that credit cards should not be allowed. Only debit cards should be permitted. **I still advocate this.**

The country manager of a major multinational bank in Pakistan said he used his credit card as though it were a debit card, and every sensible person should do the same. Then why not be straightforward, and issue only debit cards?

Inherent un-insurability of certain risks

The world's biggest insurance company insured the mortgage and property lending default risk in the US. Banks said, "hey, we know this loan is not a good risk, but we are insured by this company, so we're OK". That insurance company had to be bailed out by the US Government.

Is the mortgage default risk insurable? I don't want to sound like the Ancient Mariner. But in 1974, I was chatting with an old friend of mine in London, who was on the board of a major UK insurance company. He told me that his company was insuring the mortgage default risk. **I responded that this is not an insurable risk.**

Take the death risk in life insurance. The risk is small. It has been thoroughly studied. It reduces gradually with time, because of better medical treatment etc. It is the classical case of an insurable risk.

But the mortgage default risk is subject to unforeseeable tidal waves of economic changes which can plague an entire portfolio. This applies to defaults on first class risks. If we are talking about sub-prime risks, we have additional factors which are unfathomable. Mathematical pricing and reserving models are useless. This is a classical case of an uninsurable risk. The only wise course for the insurer is to refuse to insure these risks.

Yesterday, Asad Umar mentioned that, for political reasons, the mortgage default risk is still being insured in the US. He correctly forecast disaster for the insurers.

Efficient Market Theory

The recent financial earthquake has resulted in the **demise of the Efficient Market Theory**. This was never very credible anyway. I quote from the May 2004 issue of my firm's Akhtar & Hasan Letter:

The EMT assumes that information is available at the same time to all investors, all understand its implications, all hold the same expectations of return and these expectations are all valid. Therefore, returns over a period are a "random walk", and market prices at any time are a true reflection of value having regard to all available information.

[But] the March 2004 issue of *The Actuary* magazine of the UK reports a talk by Dr Horace Brock on the new Rational Belief Theory. This says that in a moving situation, the assumptions of the EMT as to news are not correct. Views on likely future news will differ between investors. So, different investors will build up different pricing models. These will not necessarily be irrational, but they will be wrong in the majority of cases. "Since most investors will be wrong, assets will generally be mis-priced".

Final word: go on investing

More than 50 years ago, two distinguished actuaries who looked after life insurance company investments said:

Unfortunately, however, the present is always abnormal, and the future invariably obscure, and it is doubtful whether life offices can or should credit their investment managements with more than a limited degree of skill and judgement of future trends.
(J.B.H. Pegler)

Offices would go on making mistakes because it was not given to any of them to see into the future, nevertheless they must go on investing.

(Sir William Palin Elderton)

The worst mistake following the recent financial earthquake would be a panic stricken freeze. Be driven by need, not greed. Don't leverage yourself. You are bound to make mistakes. But avoid obvious mistakes. Every winter is followed by spring. Have faith in the future, have faith in Pakistan. Follow Sir William Elderton's advice, and go on investing.

Readers should take expert advice on legal, tax and investment matters

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