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A tumultuous



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The crisis in global financial markets has raised an array of critical issues for financial institutions, regulators and governments that cover all aspects of the financial services industry and approaches to macroeconomic policy.



year

PRIOR TO THE CURRENT CRISIS, a remarkable 14-year or so economic expansion had produced growth in virtually all parts of the world. This had been a euphoric period with the globalisation of world economies, the attendant reduction in trade barriers and the massive increase in goods coming from new powerhouse economies such as China. There were also huge capital flows from the Middle East, Asia and Russia. Growth regularly exceeded expectations, governments saw revenues bloated by asset prices and consumer price increases remained low. That prosperity blinded governments, the financial sector and the community to what are now clearly seen as warning signs.

In particular, too many cheered on asset price inflation. There seemed to be no asset untouched – homes and holiday houses, artwork, racehorses, yachts and companies all became more valuable. And we convinced ourselves that this was due to a new era of global economic interaction – and that it would somehow last forever. However, asset price inflation is, and was, inflation. It was overly accommodated by various monetary authorities who ignored the very clear signal that the economy and, through that, the financial sector was travelling far too fast. This pace was well in advance of proper understanding of the systematic risks.

During that 14-year or so world expansion, two industries did especially well – information technology and finance. They were globalised, relied on continuous innovation and grew swiftly in both the new and old economies. But, just as the ‘tech boom’ came to an abrupt end in 2000 and 2001,

we are now seeing a fundamental recalibration of the financial sector. The financial sector’s long-term average share of total profits within the S&P 500 was around 15% but peaked in the past few years at 21%. The financial sector is now undergoing a correction and, by any terms, a very major and painful correction.

In the world generally, and also in the financial sector, there was a very slow recognition that a crisis was brewing. Even two or three years ago, people were lauding the low mortgage interest rates being provided to low-income earners in the United States as allowing the disenfranchised to achieve home ownership. We saw similar trends also in Western Europe. There were a few voices that rightly warned about the massive increase in household and corporate and financial sector debt levels but generally they were either disparaged or ignored.

For the banking system, the full extent of the problem started to emerge in the northern summer of 2007. It wasn’t so much that the mortgage-backed securities were starting to fail but that there was growing unease that the hedges put in place in the event of default were, at the very least, sub-optimal. The very size of the investment banks, the ever-expanding global stretch, the internal reporting of positions in net rather than gross terms and the complexities of management layers all made recognition of the problem that much more difficult. The identification of the problem was also hampered by the lack of communication between banks and, in a way, this was the result of fear of being accused of anti-competitive behaviour.

The industry still has a great future but it has to learn from its experiences and become a little bit more sober and more humble. The industry needs to recognise that it has very real social responsibilities. To the extent that asset managers underperform, people suffer and governments face higher social welfare costs. We should expect more oversight by regulators and more focus on providing not just returns but also liquidity, when needed, and security.

Fear of breaching the stringent reporting rules and Sarbanes-Oxley strictures also played a part. By contrast, in the 1980s and early 1990s, the regulatory authorities seemed to have had good communication with all the major financial institutions. The world was less complex; the institutions were less complex and investment banks did not rely anywhere near as much on proprietary trading for income. This all made for an environment where central banks could oversight the industry at a national level in a more collegial way so that problems could be more readily identified and discussed.

Fundamental change in the financial sector

But we cannot ignore the fundamental change in the financial sector. In the 1990s, aided by globalisation and accommodative monetary conditions, investment banks grew dramatically. Moving into new markets, managers had to run increasingly complex and diverse businesses across more and more countries. Importantly, banks also started to rely heavily on proprietary trading, not just in fixed income but also in equities and exchange rates. There was also the rapid growth of structured products. They put far more risk on their balance sheets and this inherently made investment banks far more vulnerable – let alone the later resort to putting risk into off-balance sheet vehicles.

Early assessments in 2007 significantly underestimated the financial sector problem which escalated sharply in 2008: concerns about mortgage-backed securities slowly, at first, but then rapidly spread to the whole array of so-called sophisticated instruments. All this was brought into sharp relief by the need to mark-to-market instruments in increasingly illiquid markets. This led to a total breakdown in the confidence that had previously allowed banks to borrow and lend among themselves – and clients began to question the security of both their deposits and their relationships.

Because we're listed on the New York Stock Exchange, I sign off many Sarbanes-Oxley accreditations; our internal and external audit processes have never been more intrusive; and the legal, compliance and risk area in the financial sector has grown more than any other. But still the problems were all missed.

For all the resources devoted to risk, I believe there had been an undue focus on operational risk and credit risk in the investment banks while the

gorilla of market risk was quietly eating all the bananas in the corner of the room. That was a fundamental problem. Few pointed to the overarching market risks. We had become victims of undue reliance on quantitative measures of risk. But those measures were necessarily backward-looking and backward-looking to an era that, in large part, no longer pertained to the financial sector. Securities had multiplied in their coverage, complexity and volume. But we were drawing on 20-to-30 year data to work out the probabilities of default.

Looking ahead

We need to rethink risk management. The way forward for risk management should be a marriage of modelling based on past behaviours with far more forward-looking judgment. It should be not unlike how good macroeconomic forecasting is undertaken.

Similarly, we have to make sure the risk management lies at the very heart of the business management. I chair the Risk Committee of Global Asset Management every month and I do it in an intrusive and often obnoxious way. In assessing risk, there is no alternative to really knowing your business. As CEO, when you know more about your direct reports' business area, then you have a risk issue! Risk is as much about people as process – and that is especially the case when, as in Global Asset Management, we are operating in 27 countries with different cultures, regulatory regimes and market structures.

Some accuse the regulators of not recognising the problems. But it was an incredibly difficult task to be a regulator in this environment. The speed with which the financial sector grew, the globalisation of that financial sector and remuneration trends have meant that regulators often really struggle to hire – let alone retain – people who can keep abreast of the financial markets. We need to have good regulation and we need to pay those people appropriately, recognising that it is a small impost relative to the potential costs.

We must also recognise that they alone cannot guarantee a trouble-free environment. Senior management and Board members need to be held personally accountable.

While much of the focus of regulation has been on capital adequacy, that needs to be broadened to include the size and the nature of the balance sheets, the concentration of risk and, most importantly, liquidity. We all took liquidity as a given but, as we've

seen with confidence, it's one of the first things that dry up in a crisis.

We must also recognise that investors cannot be protected from poor decisions. There must be some responsibility on the investment community to avoid stupid actions. Regulation in this regard must focus on better presentation of likely risks and, perhaps, a more formal and comprehensive acceptance by clients that they understand the risks.

After 20 years in the public service and now 15 years in asset management, I still raise an eyebrow at the remuneration practices in the financial sector. Those practices are now under review. One of the things that has boosted this hike in remuneration levels, perversely, has been the pursuit of transparency in remuneration. It has provided a comprehensive databank for every CEO or senior executive to be able to point to remuneration levels in their competitors locally and globally – all providing a highest common denominator.

A further observation on remuneration – we are prevented, in large part by SOX regulations and accounting conventions, from smoothing bonus pools from one year to the next. It seems crazy that, in good years, we could not bank some of the bonus pool for the next year.

The Government rescues of banks have been very sad for all who prefer capitalism – whatever that means these days – but they were necessary. I have seen the queues at banks and ATMs in London when Northern Rock crashed. The week when Lehman Brothers was allowed to collapse was truly frightening. The financial sector has a special place within our economy but I think the sector should be made to pay heavily for this. The current crisis will be with us for the next three-plus years and governments will increasingly run or influence banks for some time to come. Bankers who complain about this are being very hypocritical – there really is no alternative. It is

the price for the greed, arrogance and stupidity of the binge of the past decade or so.

The Australian financial sector is better placed than elsewhere but we shouldn't be too smug. We've had the benefit of living through our own corporate crisis in the 1980s and a very real banking crisis in the early 1990s. We have also had virtually three decades of good economic policy with our fiscal responsibility now standing us in much better stead to face a possible recession unlike much of Western Europe. We have learnt from all of this and that's one of the reasons why the financial sector here and the economy more generally still look pretty good from the other side of the world.

A comment on asset management. Clearly, there has been a now much-heightened aversion to risk that will remain for some time. That said, the asset management client community has been remarkably sophisticated in reacting to this crisis and it's a credit to trustees, consultants and the clients generally.

The long-term growth of the asset management industry won't change. The ageing of the population will be an even bigger factor now because many will have to redouble their efforts to provide privately for their retirement savings. Governments will be even less able to support retirement incomes as the pressures on public finances intensify in a way not foreseen a year or so ago.

The industry still has a great future but it has to learn from its experiences and become a little bit more sober and more humble. The industry needs to recognise that it has very real social responsibilities. To the extent that asset managers underperform, people suffer and governments face higher social welfare costs. We should expect more oversight by regulators and more focus on providing not just returns but also liquidity, when needed and security. ●

