

Crisis has resulted from honest misjudgments by finance sector

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From Mr John Reed.

Sir, I thought it might be useful to add a few thoughts to the current [discussion of the financial situation](#).

It is relatively easy to list behaviour that contributed to our financial "mess": greed, misaligned incentives, analytic failures, a tolerance for customer abuse and so forth. It is also easy to list the players: bankers, investors, rating agencies, accountants, regulators, boards, etc. I would also say the responsibility for all of this rests with "the industry", not externalities such as deregulation (there was not any that was relevant) or easy money (a banking system surely should be able to function over normal cycles) or the government.

However, at a deeper level it seems to me we made two misjudgments that date back to the 1990s and were honestly made. These judgments have simply turned out to be wrong.

The first was to assume that markets could better manage and absorb risk than institutions. Most of us believe that markets are the best at allocating capital. It is easy to take the next step and assume they will also be superior at managing financial risk. The trend started when mortgages were taken from a bank's balance sheet where they were backed by capital and reserves and sold to investors who were to absorb the risks, not in advance but as they developed, as a diminution of returns.

From mortgages we moved to today's myriad financial and "credit risk insurance" products. As distributed globally through markets and within sophisticated products to on- and off-balance-sheet vehicles these risks were to be more easily dealt with. No one assumed the risks would disappear – only that slicing, dicing, packaging and distribution would allow us to manage risk better than ever before. Our current situation simply suggests we were wrong. The capital and reserves that were thought not to be needed are being added to institutions' balance sheets. In future the border between markets and institutions will change as it should.

Our second error was to embrace the notion of risk-adjusted capital, saying, in essence, that we know where the risks are. This too was accepted as a move towards using capital more efficiently, meaning less of it in relation to gross assets. It seems pretty clear, and it has probably always been that we only know where risks are after the fact.

Presumably the future shape of the industry will seek to correct these errors. We need not dismiss the value of markets, only to understand that risks and our ability to deal with them need to be carefully considered and that distributed but interconnected networks have their own dynamic.

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