Selection through Crisis in the Banking System

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Originally published in French in *La Tribune*, 27 November 2007

The agitation and uncertainty currently running through financial markets are equally remote from business as usual as war is from peace in the life of nations. In its essay 'East and West', early-20th-century writer Paul Valéry wrote that 'peace is merely a system of conventions, an equilibrium of symbols, an essentially fiduciary construction. […] War unwinds these positions, requires the existence and mobilisation of real strength, tests the mettle, prises open the coffers, pits facts against ideas, results against renown, accident against planning, death against words.' Currently, 'the essentially fiduciary construction' of structured finance is showing cracks, and the crisis is indeed pitting 'accident against planning' as each week brings its share of bad surprises.

The crisis operates a brutal system of natural selection in sorting 'results' from 'renown'. Among institutions believed to be similar, some have turned out to be remarkably robust, whereas others have displayed unsuspected weaknesses. Until this year Citigroup appeared to be bowling along in the same category as the two other very large US banks, JPMorgan Chase and Bank of America. But this was before the market realised the extent of Citi's exposure to SIVs, the off-balance-sheet structured investment vehicles which its two competitors had kept at a safer distance, and its dependence on lucrative but high-risk activities.

In structuring Collateralized Debt Obligations, Citi and Merrill Lynch were in second and first place with, respectively, 750 and 800 million dollars in commissions since the start of 2006. Their chief executives, Chuck Prince and Stanley O'Neal, were both shown the exit earlier this month. Similarly, the market tended to lump together Merrill, Bear Stearns, Morgan Stanley and Goldman Sachs in the so-called 'bulge bracket' of leading US investment banks. But the first three have each lost around 40% of their value since January, whereas Goldman Sachs – whose president Lloyd Blankfein explained a few months ago that he had prepared himself 'for all scenarios, including the worst' – is still buoyant. It is of course difficult to tell whether this gap will be temporary or stay over the long term. What is sure is that, looking at the market as a whole, performance gaps between banks have become much more pronounced since the summer compared with the first six months of the year. Risk management has been the key to this differentiation.

At one extreme the first victims were those who ventured into complex financial territory without having developed a proper risk culture to go with it. The German banks IKB and Sachsen LB had built up massive financial 'conduits' off their balance sheets, with the inexplicable assent of the German supervisory authorities, without apparently recognising the dangers to which these constructions were exposing them. At the other extreme Goldman Sachs, not content with keeping its powder dry so far, is acting as a nursery for its rivals. It was a previous employer of both Robert Rubin, the new president of Citigroup, and John Thain, who has taken the reins at Merrill Lynch.

CEOs play a crucial role in imposing (or neglecting) sound risk assessment in the organisations they head, but they are not the only parties involved. Individual decisions, good or bad, weigh less in the judgement of investors than the capacity to sustain effective risk control over time. The share price of BNP Paribas has not suffered more than that of other European banks in spite of its controversial decision to freeze three funds in August, which had aggravated the sense of uncertainty on global markets.

Conversely, a cloud seems to be hanging above mutual banks as a breed, as they are suspected of weaker risk understanding. Credit Agricole's stock has lagged its non-mutual benchmarks. Natixis, the investment bank jointly owned by the French savings banks and *banques populaires*, has registered one of the market's worst performances, its share price dropping almost as much since January than that of the big casualties such as Citi, Merrill and Bear Stearns. This often unfair differentiation will probably persist – and may even substitute 'death for words', as Paul Valéry wrote. The creation of the US 'superfund' to mop up SIV assets is unlikely to prevent further bloodshed.

Meanwhile, survivors will have a golden opportunity to pick up attractive assets at knock-down prices. As with war, crisis 'tests the mettle, opens the coffers' and, whereas peace can make everyone happy, it is merciless in sorting winners from losers.

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