# WEEKEND **BUSINESS**

## Did crisis avoidance create one?

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Wall Street dependence on mathematical models may have cost dearly

pin hopes for rebound on Obama

NEW YORK: The U.S. steel industry, ha entered the recession in like best of he As steel preduction gives and a year inte

International Herald Tribune | 13 artiky Sumber, January J-1, 2009

**Steel firms** 

mpenies, which they inder uning New Lines

Executives are waiting to see whether infrastructure projects will be big enough to revive the

sector.

## Alpine resorts hear the ice cracking By Nelson D. School Eric Planner

## CRANS-MONTAN

Despite strong business for the holidays, ski industry is bracing for a bleak winter

ECONOMIC VIEW

The trouble with limiting

rexecutive pay

Vere explaint executive pay is nounting. After all the governme do bail out financial firms that pu contains who beloed precipit

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## WEEKEND BUSINESS

# Playing the odds: Did risk managers outsmart themselves?

### RISK, From Page 13

isk, which it does by combining the /aRs of a given company's trading lesks and coming up with a net num-er. Top executives usually know their ompany's daily VaR within minutes of he market's close. Bith margares use V.P. how

ber, Top executives sually know their company daily VAR within minutes of the market's close. Risk managers use VAR to quantify their company's risk positions to their bond. In the let 1900, as the use of dervatives was exploding, the U.S. Se-curities and Erchange Commission closed and the Converse of market risks in its financial statements for the con-venience of investors, and VAR became the main tool for doing so Given the calamity that has since on-curred, there has been a great deal of talk, even in quant circles, that this widespread institutional reliance on VAR was a terrible mistake At the very least, the risks that VAR measured did not include the bigget risk of all the possibility of a financial meldowin A risk consultant named Marc Grow aps, ''WAR as very limited ford.''Divid Einhorn, who founded Greenlight Corten and nog get the VAR was 'trela-tively useless as a risk-management wide and benefable to the statemagement

wrote not long ago that VaR was "rela-tively useless as a nisk-management tool and potentially catastrophic when its use creates a false sense of security among senior managers and watch-dogs. This is like an air bag that works all the time, except when you have a car accident: Nassim Nicholas Taleb the best-scling author of The Black Swars, has crusided against VaR for more than a decide He calls it, faily," at road."

### The Goldman legend

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In trading parlance, "getting closer home" means reiging in the risk,

which in this case mean teither getting of the mortgage backed securities of defined in your source of the security of the positions so that if they defined in your, they have be and the security of the security of the security of the security of the security Could Wat and the terr risk particips (and Wal Street's relation of the security of wall Street's relation of them 0 of a wall Street's relation of the security of the security of the security wall security of the se

### Black-swan thinking

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nificent flight Ary small error is going to reash a plane. This is why the cruss that happened was predictable. Table asys that Wall Street ersk mod-els, no matter how mathematically so-phisticated, are bogus indeed, he is the isst models have done far more harm. And the essential reason for this is one you can see and measure, but the ones you can is ead and therefore can probability that you can't imagine they would happen in your lifetime – even bough, of course, they do happen more often than you care to realize Devastating hurricanes, financial



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and create aliguidity crisits of precisely the moment when you need cash on the moment when you need cash on the moment when you need cash on the moment with the moment wi

arose Till Guldimann, an elegant, Swiss-born, former (PMorgan banker who ran the team that devised VaR, sound-ed almost mourful when he tailed about what he saw as another of VaR's shortcomings. To him, the big problem was that it turned out that VaR could be gamed.

was that if turned out had Vak Could be That is what happened when banks began reporting their VaRs. To moli-began reporting their VaRs. To moli-compensate them not just for making is profits but also for making profits with low risks. That sounds good in principle, but managers began to ma-nipulate the VaR by loading up on what Culdimann call's "asymmetric risk po-sitions". These are products or con-sitions. These are products or con-tacts that is general, generales small, reliable gains and very rarely have losses.

reliable gains and very farely have losses. But when they do have losses, they are huge. Agood example was a credit-default swap, which is essentially in-surance that a company won't default. The gaios made from selling credit-de-fault swaps are small and steady – and the chance of ever having to pay off that insurance was assumed to be minus-cule. Sadly, not minuscule enough.

One number to believe in Even more critical, VaR did not properly account for leverage that was employed through the use of options. And yet, instead of dismissing it as worthless, most of the experits 1 talked to defended it. The issue, it seemed to me, was less what VaR did and did not do, but how you though about it. Talked bays that be cause VaR did not measure the 1 percents it was worse than usefue bays that be cause VaR did not measure the 1 percents it was worse than usefue of the to experit out there was a great deal to react of the time, however imperfectly. "If you say that all nisk is unknow-ble." Greeg Berman stad, "you doo't have the basis of any sort of a bet or a trade You cannot buy and sell any-thing unless you have some idea of the expectation of how it will move." Brown puit this way: "WT" – that is bow he refers to Taleb – "says that 1 percent will dominate your outcomes. I him the enther 90 percent does matter There are thous the WaR is to say that any which case you wan't have a business." Of course, the experts I have speak-ing to were, well, experts They had a deep understanding of risk modeling and all its nhorcent limitations. They have the the short may all director of the respectanding of nisk modelings and all its nhorcent limitations. They mediately go into the shortcomings, you can't calculate a VaR number and hink you know everything you need On a day to day basis 1 don't care so

mediately go into the shortcomings You can't calculate a VAR number and think you know everything you need On a day to day basis 1 don't care so much that the VAR is 42. I care about where it was yesterday and where it is going tomorrow." Then he added "That is probably another danger Re-cause we put a doilar number to it, they attach a meaning to it." By "they." Donohuz meant everyone who wasn't a risk manager or a risk ex-pert There were the investors, the reg-culators, the board directors and chief executives. — everyone, really, who ower time forgot that the VAR number was meant in describe only what appened 90 percent of the time. That \$50 million wasn't just the times the lasst amount of the time.

That \$50 million wasn't just the most you could lose 90 percent of the time. It was the least you could lose 1 percent of the time. It was the least you could lose 1 percent of the time for the time instead of scrutinizing VAR for signs of impeding troub the they took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in a number and doubled dow. They took comfort in they could see it coming. You actual see they took comfort in the two years before the crisis his instead of preparing for it, the opposite took place to an extrem degree. All the incentives – profits, comparing the direction of taking on more and more rick, even if you half suppected it would end badly for everyone elicitos widely spread. And until the tappened, nobody on Wall Street could alford to be left behind.

Arrorate be terr behind. As the former Citigroup chief execu-tive Charles Prince 3rd once put it, "As long as the music is playing, you've got to get up and dance."

# An Irish tycoon's tale of swagger and slump

## RELAND, From Page 1

ARLEAND, From Page 1 embraced foreign investment – a rud-ical transformation that gave birth to the Cellic Tiggr and the most open and ubrant economy in Europe But beyond the glow of this sudden fourschnee that made Ineland the fourth most affluent country in the Or-ganization for Economic Cooperation and Development – the 30 nation club that includes the richest democracies – a housing bubble had begun to form. Jow interest rules, a wave of immigra-tion and a bank lending spree drow housing share of the economy to 14 percent, the highest in Europe, from 5 Developers like Dunne became mul-timilliongies and – much like the

housings share of the economy to 14 percent, the highest in Europe, from 5 percent the highest in Europe, from 5 percent the highest in Europe, from 5 the public and private equive like in the United Sites -- they became vis-ible public and cultural figures, liking large in a country usit coming to grap with its ability to show sliftle wanger. This policy makes, like their coun-trows and a full employment control from and a full employment control from and a full employment control to the short of the short for once that wanted one when the func-tions and a full employment control to the function of the short other hears toward one when the func-tions and a full employment in the Bank of the hears toward one of the four-tions had strengt more than 60 percent of the hears toward more than 60 percent of the hears toward property stopped using dama serve values plumeted. The wave repeatedly warned that the storements housing policy was ex-remeted dangerous," said John Fire Ger-son of the the the bank for bolicy center in Dublin, who has long upud that the government stanch outing dama dby rasing area. "You will now see usemployment going to 10 percent and we will experience as sharp drop in output." He shakes his head and agine "This was predictable, but the

Off the Charts: Floyd Norris is on vacation. His column will resume next week.

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Decessions to the key to Nean Dunne, horn in a house without electricity, invited 44 (riends on a two-w Mediterranean cruise in 2004 to celebrate his marrage to Gaste Killika, right

electrician. Since then he has been fina-tically knocking on doars, to no avail. "If I don't get a job in the near two weeks. I am worried about losing my house. The said. "We have no money." He looked at his number in the un-employment lines and grimmed – he had been waiting four hours and his name had not been called. "There is just no work here," he said.

tricity, instited 44 frenchs on a two-weeks of his marrage to taka be killbare. Tight is a strength of the str