'Oh, Magoo, You've Done It Again!'

by Frederick Sheehan

Alan Greenspan's instinct for self-exculpation reached new heights in the March 17, 2008, *Financial Times*. In "We Will Never Have a Perfect Model for Risk," he writes a model essay intended to eliminate risk – the risk he might be held accountable for the imploding banking system that he failed to regulate. Nowhere would the reader glean the author had a hand in the topics he speaks of with such authority. Nowhere would the reader detect a hint that the practices and models the former Federal Reserve chairman now condemns were once either blessed or ignored under his authority.

We read in the *FT*: "The crisis will leave many casualties. Particularly hard hit will be much of today's financial risk-valuation system, significant parts of which failed under stress. Those of us who look to the self-interest of lending institutions to protect shareholder equity have to be in a state of shocked disbelief."

His shock and disbelief should be directed to his own failure. If he paid the least attention to the banking system during his tenure, he would know that the banks have acted in self-interest. Self-interest took the form of sucking their institutions dry to pay themselves larger bonuses. Alan Greenspan stepped down as Fed chairman on January 31, 2006. In March 2006, Bernstein Research reported the banking system draw down of reserve-to-loan ratios and outright reserve releases accounted for 75% of the industry's pre-tax income growth since 2002. If the bankers hadn't absconded with the life preservers, annual earnings growth would have been 3% over the previous four years rather than the reported 10%. Greenspan allowed this to happen under his watch, yet, told the *FT*: "[W]e cannot hope to anticipate the specifics of future crises with any degree of confidence." We can't now and we couldn't then. "Never prepared," seems to be his motto.

In the wake of Bear Stearns' failure, Greenspan writes: "Risk management systems – and the models at their core – were supposed to guard against outsized losses. How did we go so wrong?"

One reason "we" went so wrong was to trust the then-Federal Reserve chairman. Derivatives were the cat's pajamas. He couldn't tell us often enough how they diversified risk and removed balance-sheet liabilities from the banking system. In May 2003, at a conference on Bank Structure and Competition: "Derivatives have permitted financial risks to be unbundled in ways that have facilitated both their measurement and their management… As a result, not only have individual financial institutions become less vulnerable to shocks from underlying risk factors, but also the financial system as a whole has become more resilient."

Alan Greenspan is ill-equipped to discuss the topic of derivatives vis-à-vis the financial system. Long-Term Capital Management (LTCM), a large hedge-fund with models constructed by two Nobel laureates, brought the world's financial system to its knees in 1998. Greenspan was credited with saving the world (see cover of *Time* magazine, February 15, 1999) yet he was ignorant of the relationship between banks and hedge funds.

On September 29, 1998, the Federal Reserve Open Market Committee (FOMC) met. (The chairman was apt to be more forthcoming at FOMC meetings since transcripts are not released for five years.) The staff and Fed governors briefed Greenspan on Long-Term Capital Management's counterparties – the banks that lent to LTCM. He was told that none of the banks, with the exception of Banker's Trust, had an up-to-date balance sheet for LTCM. Even this was "only a small piece of the whole action." Greenspan was at a loss: "The question is why it happened in the first place. Is it just that the lenders were dazzled by the people at LTCM and did not take a close look?" The Fed, too, may have been dazzled by the entire banking system since a Federal Reserve staff member told the FOMC that the banks "were saying the right things in terms of the kinds of risk management processes they had in place" but "the question is how effectively the banks were actually implementing them…." In Greenspan's remaining decade at the helm, this gap was left to fester. His competence was never questioned yet, in mid-September 1998, Greenspan had told the House Banking Committee "[h]edge funds [are] strongly regulated by those who lend the money."

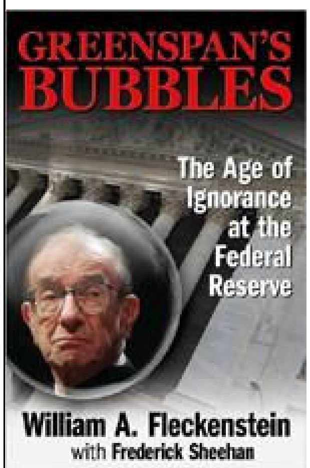
He writes in the *Financial Times*: "I hope that one of the casualties will not be reliance on counterparty surveillance, and more generally financial self-regulation, as the fundamental balance mechanism for global finance." Greenspan is not so much a proponent of self-regulation as of self-promotion. At the same September 29 FOMC meeting, Greenspan remarked: "It is one thing for one bank to have failed to appreciate what was happening to [LTCM], but this list of institutions is just mind-boggling." So boggled was the man that the Greenspan Fed allowed the financial system to leverage as never before, suck reserves from its balance sheets and write $400 trillion worth of derivatives between then and now – without so much as a dollar bill of reserves.

Today, Greenspan fears "[t]he current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the second world war…. The crisis will leave many casualties…. Since summer 2006, hundreds of thousands of homeowners, many forced by foreclosure, have moved out of single-family homes into rental housing."

It is a tribute to the man's survival instincts that he deflects attention from his personal endorsement of CDOs – at just the time those derivatives were beefing up the subprime market. In April 2005 at the Federal Reserve Community Affairs Research Conference: "Lenders have taken advantage of credit-scoring models and other techniques for efficiently extending credit to a broader spectrum of consumers… Where once more-marginal applicants would simply have been denied credit, lenders are now able to quite efficiently judge the risk posed by individual applicants.... These improvements have led to rapid growth in subprime mortgage lending."

Greenspan's chosen topic for the *FT* article, risk models, is not a surprise. He built his career by using and abusing them. In a March 1998 FOMC meeting, the stock-market bubble alarmed him: "We have an economic policy that is essentially unsustainable…. There is no credible model of which I am aware that embodies all of this…." In June 1999, he told Congress the Fed could not assess an "unstable bubble" before it popped. (No models.) Congress accepted the chairman's hallucination and the stock market ran wild. When he met with the FOMC in October 1999, Greenspan dismissed the notion of a stock market bubble because the models used by the Fed were "increasingly obsolete."

In December 2000, the bubble fading in memory, but Greenspan not having admitted there had been one, he told the FOMC: "The key question, and one that we can not answer, is whether growth has stabilized. At this point we cannot know.... The problem, as I've indicated on numerous occasions and as a number of you have commented, is that we do not have the capability of reliably forecasting a recession." Anybody outside an economist's laboratory could have answered that question: several trillion dollars had been lost in the stock market and layoffs were in the tens of thousands. But Greenspan exempted the Fed from addressing the possibility of a recession since one couldn't be modeled.



Recusing himself from responsibility to regulate the banking system, he told an audience in 2005: "The use of a growing array of derivatives and the related application of more sophisticated approaches to measuring and managing risk are key factors underpinning the greater resilience of our largest financial institutions." The former chairman squirmed on *The Daily Show*. He told Jon Stewart in September 2007: "I've been in the forecasting business for 50 years. … I'm no better than I ever was, and nobody else is. Forecasting 50 years ago was as good or as bad as it is today. And the reason is that human nature hasn't changed. We can't improve ourselves." (**Stewart lost faith in America at that point:** "You just bummed the [bleep] out of me.")

Yet, his *FT* advice column has the solution: "The essential problem is that our models…are still too simple to capture the full array of governing variables that drive global economic reality." This advice will be quoted, university faculties will nod in approval, central banks will calculate third-derivative proofs of Greenspan's wisdom, even as the financial system tries to salvage itself. He can soak in his bathtub, much as the cartoon character who left ruin behind, and exclaim, "Oh, Magoo, you've done it again!"

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