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Cc: .

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Subject: 10 things the Credit Crisis reminded us.

Chris, I hesitate to answer the question "What did you learn from the Credit Crisis?", but here's a shot at some things we already knew, but for which the lessons bear repeating:-

- 1) Liquidity is more important than capital; most entities which go bankrupt do so because they run out of financing, not because the value of their assets falls below the value of their liabilities
- 2) Trading and investment discipline are eternally important; during the good times it is extremely difficult to ensure that competitive pressures do not erode discipline (no MAC clauses, Covenant-Lite, deal-contingent trades, pro-cyclical risk metrics, confirm backlogs, this time it's different - there's been a paradigm-shift, that could never happen, etc....)
- 3) Whilst 2) says we have to worry during the good times, the bad times are worse; we have to be wary of increased operational risk as business operators stretch to achieve targets and stress impacts control function operations (see BSC 10Q disclaimer)
- 4) Market, Credit and Liquidity (i.e. financing) exposures are inextricably inter-twined; it is essential to have an holistic view of risk. Easier said than done, as risk has a way of lurking in unexpected places (e.g. Auction Rate securities) and in the interstices between the traditional risk management disciplines, it means that risk metrics based upon netted exposures need to be supplemented by concentration caps on legs and gross exposures as well
- 5) Liquidity is the ultimate useless concept - plentifully available when it's not needed, never present when it is. Equity-sufficiency metrics need to be based on anticipated liquidity-availability during stressed market periods, not on normal-market experience
- 6) As a metric whose properties change dramatically during crisis periods (and for which measures based on normal-market experience are therefore useless), Liquidity is closely followed by Correlation. Level III products for which the valuation and risk models require correlation as an input parameter (including e.g. Super-senior CDO tranches) should be stressed to extreme levels to set a threshold on acceptable exposures
- 7) Since correlation between hitherto unrelated markets with no rational economic linkage is driven by forced liquidation and risk-aversion during stressed market periods, it is not sufficient to look at each asset class in isolation when setting a threshold on "How much is enough exposure?" We need to be prepared to think the unthinkable and look at aggregate exposure across all markets simultaneously during stressed market circumstances
- 8) Carry trades are potential killers. Easy to enter and seductive in their apparent profitability and benign revenue volatility during the good times, they have a habit of blowing-up periodically and offering little opportunity to escape in time
- 9) All the above can be summed-up by saying that good risk management is all about good management, and not about risk measurement. The focus over the last few years has been on development of quantitative risk metrics; these are all very well, but cannot substitute for sound business judgment and good management
- 10) Finally, to paraphrase Walter Bagehot, "When a banker is required to prove his credit-worthiness, in fact he knows that his credit is already gone".