BusinessWeek online

Close Window

JUNE 12, 2006

COVER STORY

Inside Wall Street's Culture Of Risk

Investment banks are placing bigger bets than ever and beating the odds -- at least for now

On the 31st floor of a skyscraper overlooking Times Square one recent spring day, a dozen or so of Lehman Brothers Inc.'s (**LEH**) top executives filed into a conference room to run through risks, relive past financial crises, and worry about new ones. They analyzed how much money the firm might lose if the markets were buffeted like they were after the terrorist attacks of 2001. They pored over complicated risk models showing how tens of thousands of trading positions and financial contracts with clients would fare in the event of an Avian flu epidemic. They tested all conceivable scenarios that might put Lehman in harm's way. "We are in the business of risk management 24/7, 365 days a year," says Chief Administrative Officer David Goldfarb.

Wall Street has always been about taking risk. But never has the "R" word been such an obsession for the men and women who rule the nation's biggest investment banks. Never have they had to reconcile so many bets made on so many fronts. The conditions have been ripe. Historically low interest rates and relatively calm markets in the last few years have allowed a new type of firm to flourish, one that acts primarily as a trader and only secondarily as a traditional investment bank, underwriting securities and advising on mergers.

Goldman Sachs' CEO Henry M. Paulson Jr. has led the charge. Major Wall Street firms have watched with envy as Goldman has repeatedly racked up record earnings on the strength of its trading business. The biggest stunner came in March when Goldman announced that in three months it had tossed off $2.6 billion in profits -- nearly half as much as it earned in all of 2005 -- on $10 billion in revenues. Not coincidentally, Goldman also put a record amount of the firm's capital at risk of evaporating on any given trading day. Its so-called value at risk jumped to $92 million, up 135% from $39 million in 2001. "[Goldman is] a horse of a different color now," says Samuel L. Hayes III, professor emeritus of investment banking at Harvard Business School.

As Paulson prepares to move to Washington to serve as U.S. Treasury Secretary, Goldman shows no sign of easing up. Nor do its followers. This trading boom, fueled by cheap money, is fundamentally different from the ones of the past. When traders last ruled Wall Street, during the mid-'90s, few banks put much of their own balance sheets at risk; most acted mainly as brokers, arranging trades between clients. Now, virtually all banks are making huge bets with their own assets on many more fronts, and using vast sums of borrowed money to jack up the risk even more. They're shouldering risks for their clients to an unprecedented degree. They're dabbling in remote markets from Brasilia to Jakarta, and in arcane products like credit-default swaps and catastrophe bonds. Led by Goldman, many investment banks now do more trading than all but the biggest hedge funds, those lightly regulated investment pools that almost brought down the financial system in 1998 when one of them, Long-Term Capital Management, blew up.

What's more, banks are jumping into the realm of private equity, spending billions to buy struggling businesses as far afield as China that they hope to turn around and sell at a profit. With $25 billion of capital under management, Goldman's private equity arm itself is one of the largest buyout firms in the world, according to Thomson Venture Economics. The moves are not unrelated to trading. In both cases, banks are flocking to exotic and inaccessible markets where there aren't many others to fight for profit. Counterintuitively, they're seeking out the investments that would be the hardest to get rid of in the event of a disaster. They're betting, in other words, that handsome returns when times are good will make up for losses when things turn ugly.

THINNER SAFETY CUSHIONS

So far, the rewards are justifying the risks: Big investment banks are booking record profits, and their stocks have zoomed, up 64% since 2001. But once-calm global markets are getting rocky as interest rates rise, choking off the easy money. Fears of more rate hikes to come have triggered sell-offs in stocks, bonds, and currencies around the world since early May.

That's raising the stakes for arguably the biggest game of risk ever to play out on Wall Street. If banks succeed, they'll rack up even bigger earnings. But if they borrow too much money for their trades or take on more risk than they can manage, the wreckage could be considerable. "A world where huge amounts of leverage have been brought into the system is a dangerous world," Berkshire Hathaway Inc.'s CEO Warren Buffett observed at his most recent annual meeting. And "as interest rates rise...people will stretch even further and take greater risks," warns John H. Gutfreund, senior adviser at the investment bank C.E. Unterberg, Towbin and former CEO of Salomon Bros. Andy M. Brooks, head of equity trading at investment manager T. Rowe Price Group Inc. (**TROW**), puts it more bluntly: "If people step out too much, they're going to get whacked."

Just as investment banks are taking more risks, so are millions of individuals. They've bid up prices and accepted thinner safety cushions in the past few years on commodities, international stocks, and shares of the riskiest U.S. companies. Penny-stock trading has soared, up 640% from three years ago. Gambling and casino stocks have risen sharply in recent years. And home buyers have leveraged up, buying more expensive houses with more complex mortgages. "Investors seem to be displaying signs of pure fearlessness," James Montier, global equity strategist at Dresdner Kleinwort Wasserstein, summed up recently. Says James Grant, editor of *Grant's Interest Rate Observer* and a financial market historian: "The world is stretching for return." The last time investors stretched so far, during the dot-com boom of the late '90s, the results were disastrous.

But the biggest danger may be on Wall Street. As the banks trade in ever-more-obscure products with ever-more-opaque clients such as hedge funds, observers worry that they might not be able to settle their trades in the event of a market shock, intensifying the damage. "The heartburn," says Robert Fuller, the principal and founder of Hopewell (N.J.)-based financial adviser Capital Markets Management, "could be anywhere from something you can cure with a Tums to death by trauma."

It might not take a major meltdown to send bank profits tumbling: Scandals might get them first. Suspicions are rising that bank traders are acting on nonpublic information gleaned from their clients. So-called front-running is nothing new to Wall Street watchers, but with so many different kinds of financial products being traded today, and so many parties involved, the temptations are unprecedented. The Securities & Exchange Commission has "very active examinations and investigations under way," says Lori A. Richards, an agency director.

Yet for all the risks they're taking on, banks insist they're safer than ever. They've hired many of the greatest mathematical minds in the world to create impossibly complex risk models. They deal in so many markets that the chances of all of them going haywire simultaneously appear minuscule. And traders have been feathering banks' nests for five years. They've produced record earnings and boosted asset bases to unheard of sizes, making even bigger bets possible. Although the scale of trading activity has soared, risk now accounts for about the same percentage of brokers' total equity as it did in the 1990s, notes Tom Foley, financial-services credit analyst at Standard & Poor's, like *BusinessWeek* a unit of The McGraw-Hill Companies.

The arguments have been good enough for investors, who have been cheering banks on to raise their risk profiles even more. If you thought the recent volatility in the emerging markets would have discouraged them, think again. Even though such jitters have knocked Goldman's stock price down 9% since May 9, wiping out $6.8 billion in market value, analysts from UBS, Merrill Lynch, and Punk Ziegel & Co. have either upgraded or reiterated their support for the stock. They expect that any rise in volatility will create even more trading opportunities. The question is, how far will Goldman and the others go?

From the looks of it, pretty far. All of them are ramping up teams of so-called proprietary traders who play with the banks' own money. Merrill Lynch is expanding a "strategic risk" team for a wide variety of equity securities. More than 100 UBS (**UBS**) traders have migrated to a hedge fund the bank has seeded and is marketing to outside investors. The appetite for proprietary traders is growing "exponentially," says Richard Stein of executive recruiting firm Korn Ferry International. Banks are paying up, offering some traders $10 million to $20 million a year, he says.

Banks are building out their infrastructures, too. UBS already boasts the largest trading floor in the world in Stamford, Conn., where more than 1,000 traders inhabit a 103,000-square-foot space that was last updated in 2002. It is no longer big enough. "We're expanding," says Mark E. Bridges, a senior executive. The Swiss bank is so eager to keep its employees focused on the task at hand that it has sprinkled six concession stands that sell Starbucks (**SBUX**) coffee around the trading floor. Across the street, the Royal Bank of Scotland expects to start construction of a 95,000-sq.-ft. space this summer. Citigroup (**C**), meanwhile, is focusing on squeezing more bodies onto its three main trading floors. Right now there are twice as many technologists crunching analytics and market data as there are traders on the floors. By 2008, the ratio could be 1 to 1. They're needed: Transactions have become so complex that some traders have eight computer screens at their desk.

Wall Street's exuberance is palpable as the pain of big blowups of the past recedes from memory. John Meriwether, the former head of Long-Term Capital Management, is now considered a hero to some. On June 28 the industry newsletter *Alternative Investment News* will give Meriwether a lifetime achievement award for pioneering alternative investment strategies. (Meriwether, who now runs a fund called JWM Partners, doesn't plan to attend the event.)

"THE MACHINE WORKS"

To some extent, the jubilation is understandable. Banks in recent years have been remarkably successful in shrugging off crises, from the downgrading of General Motors Corp.'s (**GM**) credit to junk status last spring to the destruction of New Orleans, that could have triggered meltdowns. "Right now everything on my screen is flashing red," said Michael Alix, chief risk officer at Bear, Stearns & Co. (**BSC**), on May 11, the day after Federal Reserve Chairman Ben S. Bernanke raised interest rates, sending the market gauges he was looking at tumbling. But "that doesn't make me nervous," says Alix. The bank has built such powerful computing systems that Alix can reevaluate every day the risks of thousands of positions across the firm's trading businesses under various stressful scenarios to be sure the firm doesn't hold too much of any risky investment at any one time. That type of analysis used to take a week to complete. "The machine works," he says. The degree to which risk management has evolved in the past few decades is astonishing, say analysts.

As is the development of trading itself. Morgan Stanley's (**MS**) John Shapiro, who runs one of the world's most profitable energy and commodities trading operations, joined the firm two decades ago. Back then his group traded mostly metals and crude oil futures. Now it trades a long list of energy products and owns several power plants. Those hard assets have been hugely advantageous, throwing off revenues in their own right and giving Shapiro's traders a much better sense of the overall market than the grinders in the futures pits have. "It's not that I'm looking to take on extra risk," says Shapiro. "But if opportunities we come across require us to do it...I will not hesitate to ask for more."

Some on the Street argue that such confidence is misplaced, and that the relative stability in the global markets since 2003 has lulled traders into a false sense of security. So much speculation has crept into commodities markets, for example, that in April they were trading at prices 50% higher than they would have been based only on fundamentals, estimated Merrill Lynch. A sharp sell-off followed in May. Are bank traders and hedge funds living on borrowed time? One senior bank executive thinks so. He worries that at any moment volatility could spike to levels never seen before.

How the markets will respond to such an event "is up in the air," says Leslie Rahl, president and founder of Capital Market Risk Advisors Inc., a New York-based consultancy. That's because banks are dealing more with unpredictable clients like hedge funds and in less familiar financial products like derivatives of derivatives. They also use any number of risk models whose predictions vary wildly depending on the assumptions. For example, JPMorgan Chase & Co. (**JPM**) estimates on page 76 of its annual report that in 2005 its trading portfolios were at risk of losing $88 million on any given day, a pittance compared with its annual profit of $8.5 billion. The figure it cited is called value at risk, or VAR, which describes the total losses across all positions, from pork bellies to Iraqi bonds, that could be sustained in any single day under normal trading conditions. On average, major investment banks report VAR of $56 million.

But such backward-looking estimates don't capture the extent of the banks' risks. On the very next page of the JPMorgan report, the bank tells investors that losses could have soared to as much as $1.4 billion over, say, a four-week period last year if an abnormal event had occurred. That figure was based on a "stress test" it performed on its books, another kind of risk-modeling technique.

The good news? At least banks are reporting their VAR numbers; they didn't before the late 1990s. The bad news is that JPMorgan is one of only a few banks to divulge results of a stress test or any other measure of unusual risk. Investors, guided mostly by VAR amounts, have no idea what might happen in an abnormal event. "Banks are treating exceptions [to the norm] as adjunct risk," says Nassim N. Taleb, a professor at the University of Massachusetts Amherst and former proprietary trader at UBS and Credit Suisse First Boston (**CSR**) who has written extensively about the limits of VAR. "But when you ride a plane, you don't worry about your coffee being cold. What you worry about is the risk that your plane will crash."

Wall Street chiefs are aware of risk models' limitations. During an investor conference last November, Goldman's Paulson was asked to talk about his readiness for a big blow to the financial system. Paulson issued a litany of warnings. The main risk measure Goldman discloses, VAR, "always assumes that the future is going to be like the past," he said. And even though the bank regularly uses many different models to test its resiliency to various disaster scenarios, no one can correctly predict where the next disaster will come from. "The one thing we do know," Paulson explained, "is [that] if and when there is another shock, things you hope wouldn't correlate [or trade in tandem] are going to correlate." Seemingly unrelated assets like, say, silver and options on Japanese commercial mortgages could all go into free fall.

Yet, even if the financial markets don't crash, banks' aggressive moves into trading threaten to scare off clients who wonder where they will rank if a panic triggers a sell-off. Will the bank perform its fiduciary responsibility to its client and execute its trades, or will it cover its own hide?

If banks are seen misusing client information to gain a trading edge, they could find themselves right back in the regulatory quagmire that followed the scandals of the '90s, when they were accused of pushing lousy stocks on unsuspecting investors to win what were then lucrative underwriting deals. Those abuses cost Wall Street more than $1.4 billion in fines. There's no telling what this cycle's price tag could be if the banks mismanage relationships in new ways. The New York Stock Exchange is investigating a major investment bank to see if it's giving a hedge fund it runs preferential treatment. And the SEC is examining whether banks have sufficient controls to prevent information about customer positions from being passed on to traders. Fines aside, the hit to banks resulting from the loss of their reputations could be far bigger this time. It's one thing for them to burn individual investors in order to serve big clients; it's another for the banks to burn big clients to serve themselves.

So why, then, are banks racing ahead to build bigger, more complicated trading operations, risking huge losses and long-term damage to their credibility if things go wrong? For one, the banks think they can handle the risks. For another, their shareholders and clients are demanding it. Consider what happened at Morgan Stanley. Its stock price trailed many of its rivals for four years in large part because the bank wouldn't take on more risk. As it remained cautious, the gap between its bond-, currency-, and commodities-trading revenues and those of Goldman ballooned to $1.7 billion in 2005, up from less than $500 million in 2001. Some say that's one reason why former CEO Philip J. Purcell lost his job. (Purcell did not return calls seeking comment.)

When current CEO John J. Mack accepted the post in July, 2005, he made it his mission to bolster areas Purcell thought risky, including mortgages, equity derivatives, and junk bonds. In April, he created a new group that trades residential loans and other securities. He has also increased the private equity capital pool by $1 billion, to $2.5 billion. The result: Morgan Stanley's VAR is 61% greater than it was in 2003, and the bank is closing the revenue gap with Goldman.

Investors argue that trading is booming now while most traditional banking businesses are languishing. Big firms can no longer subsist on underwriting or stock and bond trading as the combination of more rivals and cheap electronic trading drives down profit margins. "Wall Street doesn't get paid to not take risk anymore," says Merrill Lynch & Co. (MER) financial-services analyst Guy Moszkowski. The big investment banks add value by "absorbing the risk that their clients are looking to get rid of."

Businesses that once accounted for most of the profits at investment banks are now viewed more as gateways that lead them into the lucrative land of risk. Even mergers and acquisitions, an area that's doing well now, is serving a larger goal. Say a private equity firm acquires a struggling foreign company but worries about currency and electricity price fluctuations. In the past a big bank advising on the deal might have tossed in a currency trade to relieve the firm of some of that risk. Now, it will take on virtually any risk the client wants to hedge, from jumps in electricity prices to hurricanes. And it might also go in on the acquisition itself with its private equity arm, taking on far more risk. Bankers call this a triple play: M&A, trading, and private equity all in one deal. The only sure money is the M&A advisory fee, a pittance compared with the potential private equity gains down the road.

FAT TAILS

More surprising, banks are also regularly agreeing to buy huge blocks of stock from trading clients even when they know they will likely lose money on the trade. It's a high-risk, low-reward endeavor designed to keep clients coming back to pay for more lucrative business in the future. Some executives estimate the dollar volume of such transactions has doubled in the past few years. Yet banks have barely broken even on about 30% of their big block trades this year, according to Thomson Financial (TOC). That's because the share prices often fall during the time they hold the securities on their books. Even so, "banks are falling all over themselves to bid on blocks," says T. Rowe Price's Brooks. "It's not for the faint of heart."

In the bond markets, money managers ring up traders routinely and ask them to bid on messy multibillion-dollar portfolios of bonds and other financial products with expiration dates ranging from 2 to 10 years. "You have a trader committing in one or two minutes to a trade that could lose or make tens of millions of dollars," says Thomas G. Maheras, head of capital markets at Citigroup.

Risky though the trading may be, it's the forays into private equity that keep many risk managers awake at night. Fully formed companies are the hardest assets for banks to get off their books if things go wrong; just try selling a pipeline in the middle of a financial panic. Private assets are also difficult to value on a daily basis and don't fit neatly into risk managers' models. Against this backdrop, VAR numbers seem utterly inadequate.

What risk managers particularly fear are "fat tails." The term comes from the shape of a bell curve of probabilities, in which the long, thin tails on both ends represent extremely rare outcomes. Fat tails mean catastrophes are more likely than one would guess given normal day-to-day fluctuations. Risk managers are quick to point out that world events don't always hew to the shape of a bell curve. "The abnormal is really abnormal," says a risk manager who was part of the team that bailed out Long Term Capital Management.

At least one big investor isn't taking many chances on banks. Anton V. Schutz, who manages the $131 million Burnham Financial Services Fund, held almost every investment bank stock last year. Now he holds only Morgan Stanley. Why? "Investment banks are trading like there's no risk in the world," he says.

Wall Street moves in cycles of excess. Before the current cycle turns, the odds are good that at least one bank will take things too far. That's what happened in the '80s, when banks churned out an array of new products like junk bonds and created whole new markets for them, then abused those markets for their own ends. It happened again in the '90s as bankers cashed in on the Internet bubble. "There's always someone who doesn't see that the turning point has been reached," says Frank Fernandez of the Securities Industry Assn. It's possible that all of the banks will show more restraint this time as they chase returns in the red-hot risk market. But don't bet on it.

By Emily Thornton, with David Henry in New York and Adrienne Carter in Chicago