

## Institutional Memory: How did we forget about credit losses?

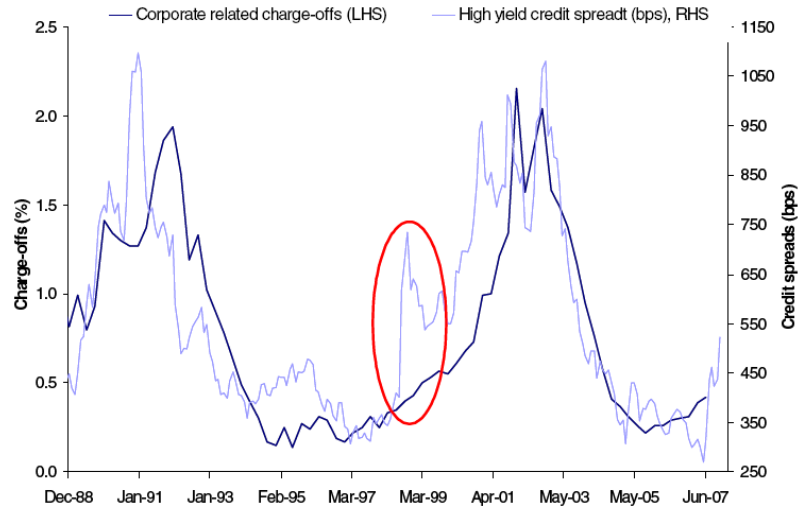
In discussing sub-prime related losses at a recent investor day, the Chairman of UBS said “the people concerned and their supervisors failed to recognise properly the size and changing nature of the positions that were being established. **Risk control and finance had the numbers but failed to realise in time what they truly meant**”. We know that UBS’s experience with credit losses is not unique. Many years from now, blessed with the benefit of hindsight, market commentators will accurately pinpoint the cause of the difficulties that the global financial system is experiencing today. In the meantime, it appears that one of the major contributing factors was a failure to heed the warnings of institutional memory.

The utility of institutional memory parallels that of personal memory. As individuals, memory plays a key role in life. Memory represents our aggregate knowledge gained through traditional education, trial and error, and experience. As small children we all learned and committed to memory the concept of ‘hot’. As a result of memory, none of us needs to put our hand in a fire to understand the consequences associated with that choice. Drawing on our memory resource helps us manoeuvre through life’s trials and tribulations. Similarly, institutional memory represents the collective (or aggregate) knowledge and experiences of all employees in an organization. Like an individual, institutions draw upon this resource as needed to navigate the decision making process.

Experiencing problem loans is not new for banks. Lending is an inherently cyclical business. Why then were many loan and risk officers unable to “realise in time what they [the numbers] truly meant”? An aspect of institutional memory tells the story. According to a 2003 study by Allen Berger and Gregory Udell, the passage of time erodes institutional memory’s efficacy. According to their study, “the deterioration in loan officer ability is partly due to a proportional increase in officers that have never experienced a loan bust and partly due to the atrophying skills of experienced officers as time passes since their last experience with problem loans”. Imagine the influence on decision making within a bank following the 1990 recession or the telecom lending bubble. Like a college freshman the day after his first big night out, risk managers likely promised themselves that “never again” would they be so reckless. The millions of dollars of losses due to poor loan decisions would have dealt risk managers the upper hand in internal negotiations to commit to incremental risk. However, as time passed, the expected or predicted losses on new business failed to materialize. Accordingly, corporate power and influence slowly slipped from the hands of risk managers into the hands of risk takers. As economic prosperity continued to gain momentum, institutional memory of past cycles faded away. With power strongly entrenched, risk takers demonstrated a growing propensity to take bigger risks with fleeting concern about the downside. Credit spreads over the last four years demonstrate that broad risks were being accepted with tighter and tighter spreads (banks were not being properly paid for the risks they were underwriting). This cycle likely culminated in the covenant free lending that was being advanced for private equity financing up until the music stopped this summer.

With renewed awareness that risks do exist in lending, the credit adjudication process has begun the process of change. Outside of sub-prime related woes, the recent quarterly results of the banks have shown a marginal deterioration in credit quality. While loan losses that Canadian banks are experiencing remain well below historical levels, they have begun to slowly rise. As outlined in the following chart, corporate related charge-offs have demonstrated a strong correlation with high yield credit spreads. While

high yield spreads have risen steadily since bottoming this summer, they still remain well below their levels during previous times of financial turmoil. If historical relationships remain intact, it is highly probable that Canadian banks will continue to increase loan loss provisioning. Given what we know today, it is reasonable to expect that loan provisions are likely to move higher and return to at least historical long-term averages. In 2007, Canadian banks reported provisions for credit losses that were approximately half of long-term average levels.



As institutional memory faded, investors stretched for higher yield by imprudently overpaying for risky investments of the structured and levered variety. Bull markets have a tendency to convince investors that the risk component in the risk / reward relationship has changed, as demonstrated by the many articles that have been written this cycle extolling the virtues of derivatives to eliminate risk from the market. The additional unknown in this credit cycle is the absence of experience with many of the innovative and incredibly complex investment structures that the market must now value. The reality is that many of their creators have never seen a bear market. Thus, bear market scenarios and probabilities were not accurately captured in their original models.

After a long period of above average performance (such as the current bull market or extended economic cycle), there is a tendency to forget the bear markets of the past. All things revert to the mean. Sionna cautions investors to remember the past as a guide to the future. Memory of past realities should be ignored at your own peril. Dust off the old grey haired gentleman or woman sequestered in the small back office. Take him to lunch. Listen. Embedded in the rambling yore of the good ol' days are the signposts and guidelines to navigating today's market. Ignoring institutional memory is likely to enable you to experience it all once again!

Experience is simply the name we give our mistakes.  
Oscar Wilde

Colum McKinley  
Portfolio Manager  
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