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Dislocations

Dislocation: dis-lo-ca-tion (\ˌdis-(ˌ)lō-'ka-shən): a disruption of an established order

The financial world has undergone a dislocation of epic proportions, one that is rivaled by only two such situations in our lifetimes: the Great Depression and to a lesser magnitude the interest spike and related chain of events of the early 1980's. Financial institutions, and even more profoundly the world financial order, have been found to be standing on foundations of sand, and dynamics/financial behaviors/paradigms/systems that we took for granted are not effective, or at the very least stumbling along in a state of disarray and confusion.

As our 'rose-colored glasses' (spawned by over-optimism, greed, laziness, ignorance and unjustified trust) have been taken away and replaced with Coke-bottle lenses with Vaseline smeared on them, we are confronted with the critical endeavor of recreating nothing less than our way of life and arguably the most important underpinning of it, our financial system.

As we furtively strive to deal with this very difficult situation, it is instructive to take stock of where we are and how we arrived at this point, determine what we need to do differently, and create both a roadmap and a 'stride' for succeeding going forward. We will ultimately solve the major issues confronting our financial system, but at great cost and will surely come out of this crisis in a very different place.

Our World Has Changed

Perspective: This dislocation is different and more troubling than any other in history, in large part because it almost triggered the collapse of the world's financial system. Furthermore, it was not caused by an advancement of human knowledge and wisdom. Interestingly, there are a number of parallels to the fall of the Roman Empire. Over the history of the civilized world (and just how civilized the world has been is open for debate, although this will not be explored in this article), the economic order has evolved due to advances of mankind: from agrarianism to manufacturing to technology to information and service. The crisis we are faced with today, however, was caused by widespread business practices where society's hard learned lessons were ignored:

- The financial system needs to be based on trust (in people, in the system itself), and the resulting belief that it works; there has been a considerable amount of activity that almost any observer would describe as untrustworthy
- Accurate, objective analysis is critical, and there were many instances where the quality of analysis was faulty

- Greed kills, sooner or later

Joseph Schumpeter, the famous Czechoslovakian economist, observed in the 1920's: "Capitalism moves forward following a process of creative destruction. Inevitable cycles of expansion and retraction are not only survivable but are in fact the secret of capitalism's extraordinary power to inspire innovation and progress." It would be completely inaccurate to describe the current financial crisis that has occurred as the result of 'creative destruction'. The root causes of this crisis are much darker.

How did we get to where we are?

- Unjustifiably easy credit was offered to homebuyers who very logically couldn't have been expected to be able to service their mortgage loans. One of the great American ideals is homeownership, which in and of itself is a lofty goal, but another great American ideal is pulling oneself up by the bootstraps and making ones' own way; these two ideals collided with tragic results for the real estate market and the American public. A substantial price bubble was created and inevitably burst, as many have before it, but this time the entire American society was hurt badly as opposed to individual investors in past bubbles.
- Asset managers making ambitious claims about investment returns they said they couldn't possibly achieve, and others committing outright fraud
- Rating analysts not adequately analyzing securities, causing them to be overrated and underpriced
- Investment bankers and others facilitating transactions built on elements that had not been properly vetted, and which have turned out to have crushing levels of risk and unforeseen financial liabilities

Macro issues abounded:

- The **banking system** almost collapsed, and may have had it not been for considerable government intervention, which has raised a host of other profound issues. An enormous amount of bad loans were made as the result of capricious underwriting, leading to huge amounts of bad assets on banks' books and causing a paralyzing level of fear for making further loans.

- The **financial markets** 'froze'. The flow of capital slowed to a trickle because lenders did not believe that borrowers were credit-worthy; ironically, the thought process evolved from lending money to anybody to lending money to no one. The markets are just beginning to thaw, a year later.

- **Complicated financial instruments** confused and overwhelmed the system, creating enormous risk. Counterparties, partners in transactions, did not understand these vehicles they were buying and selling (and in many cases how their counterparts were managing their own enterprises) … and the risks they were taking on. A certain notorious business operation has long held the notion that "Be close to your friends, and closer to your enemies".

- The **real estate market** plunged into its worst cycle in decades, and possibly ever. This collapse was caused by a number of dynamics:
  * Real estate was sold and loans were made to individuals or companies whose financial positions were not strong enough to service their financial obligations.
  * An enormous price bubble in real estate was created by the over capacity over appetite of buyers, and it burst with a vengeance. An enormous amount of delinquencies and foreclosures ensued, real estate values plummeted, lending institutions pulled back on credit, and a huge inventory of uninhabited properties resulted**.**

- The **rating agencies** have been called to task over their role in the current situation, and a number of vexing questions have been raised:
  * How are they analyzing companies and investment vehicles?
  * How are they to be paid for their rating services? Are there conflicts of interest imbedded in their client relationships?
  * How will they be operating going forward?
  * How will they be regulated?

- **Consumer attitudes** have been more negative than ever since they began being monitored in the 1960's, although recently they have improved marginally as economic and financial stabilization is beginning to occur; some think these improved attitudes are nothing more than 'irrational exuberance'. The population at large is scared, more than just worried. The widespread view is that the current situation is beyond a cyclical downturn and is perceived as a failure of the system. Uncertainty about the financial system, rising unemployment, restricted credit, and a depressed housing market have all contributed to plummeting consumer sentiment.

- **Government responses** in the form of rescue programs of various types are beginning to fix the problems within the financial system (banks and insurers) and key industries (automotive), and are gradually beginning to calm fears. Substantial efforts to revise the nation's financial services regulatory infrastructure are underway, conceived to both address current issues and create a more shock-free system in the future. A number of vexing problems have arisen, however, that will be very difficult to solve:
  * Well intentioned programs to interject capital to troubled sectors of the economy have been slow to take effect
  * Massive budget deficits are building, which will lead to substantial debt servicing obligations in the future and consequently depressed economic growth
  * The government owns stakes in huge corporations (with the implication of socialistic-type government in the United States, for crying out loud!), and is being perceived as making broad decisions on which corporations will survive or fail.

- **International relations** (financial and otherwise) are particularly stressed, although many would argue that this is a normal state of affairs
  * Business/economic policies undertaken by countries are seen as counterproductive to their trading partners. The European Union is basically a great concept, but its members (27 countries at the time of this writing) have different views as to how to solve their economic and financial problems

* Many countries are blaming the United States for the world's economic predicament

- **Risk management**: what is 'risk management', and is it effective?
  * Understanding that things that can go wrong (either known or unknown), and making sure the adverse affects do not cause crippling and irreversible harm.
  * A fundamental question about the efficacy of risk management that is begging to be asked is "how did so many elements of this financial disaster occur that had aspects and implications of risk that no one either understood or quantified anywhere close to properly, or didn't bother to look at?"

Are there precedents for the current situation? What have we learned from historic economic and financial failures?

<u>The Interest Rate Spike of the Early 1980s: An Epic Dislocation in the Life Insurance Business</u>

<u>Perspective:</u> The life insurance business was a relatively straightforward business from its inception and early growth years in the nineteenth century up until the late 1970's. Whole life insurance, with a fixed rate of return on its savings component in the 4% range, was sold by career agents who were 'captive' to (sold exclusively for) their companies. The business model clearly appeared to be sound. An inside joke at life insurance companies (insurance humor being what it is) was that "All you had to do was turn the lights on" and the business worked.

An unprecedented economic event occurred over a span of 4 1/2 years, from late 1976 until the third quarter of 1981, that changed all that. Interest rates spiked to levels never before seen in the United States. The prime rate rose from a cyclical trough of 6.25% in December, 1976 to unheard of levels of 20% or higher in April, 1980, crossed the 20% threshold again for a two month stretch in December, 1980 through February, 2001, and yet again from May through September, 2001. This shock challenged literally everything about the life insurance business:

1) Guaranteed interest rates offered by whole life products were not (at all) competitive with other investment options consumers could get. Policyholders were borrowing heavily from their policies, as the loan interest rates were well below rates they could earn on their investments. This dynamic spawned the financial strategy known as "buy term and invest the difference", and drove insurers to develop products that paid competitive (relative to the market) rates, such as Universal Life

2) Bond values were far 'under water' (below cost), as the rates of interest they paid were substantially below what investors could earn on other instruments. Without wanting to realize capital losses on their sale, insurers generally had little choice but to hope for a lower interest rate environment.

3) Given that cash flow was leaving companies in substantial and potentially crippling amounts, many companies made one of two disastrous choices (and often both):

- They paid their producers first year (heaped) commissions to rewrite business already on the books so it wouldn't surrender, ruining the profitability on that business
- They sold business offering current interest rates (GICs were an egregious example) to raise cash, but they weren't able to invest the cash at comparable rates, thus locking in negative spreads and losses. This dynamic spawned the creation of a critical financial/ actuarial technique, Asset Liability Management.

As companies' profitability reeled from these and related problems, they looked much closer looks at their profit fundamentals and sought ways to improve results. One area of many came under intense scrutiny … distribution costs. In this new environment, companies across the industry learned that an entirely new distribution model was critical for survival, let alone success.

My company (a life insurer) undertook a major strategic analysis in 1983 … products, markets, distribution were the key areas, but not the only ones. I was a member of the four person team heading this critical project. Overheard in one of our working sessions:
"If we could only come up with a diamond in the rough", *said one of the other members on the project team, a close friend of mine.*
"We've already had it, and it endured for over 100 years.", *I replied.* "We now need to develop significantly different solutions, and more fundamentally focus on entirely new ways to think about our business".

The life insurance industry had reached a dislocation. All of its strategic dynamics changed, and its companies were forced to change with it in order to survive. It took many years; many industry observers would say more than a decade, but the industry was able to essentially reinvent itself and prosper.

Now, in 2009, the life insurance industry is in the throes of the current dislocation as is the entire financial services industry, and its companies are faced with the challenge of responding to a new set of dynamics.

Conclusion (a misnomer): Enduring Fundamentals in a 'Relocated World'

"Where do we go from here, and what have we learned to help us arrive there safely and prosperously?"

Dislocations have occurred many times in history, and have occurred in many societal areas, changing many aspects of life profoundly:

- Economy: Agrarian, manufacturing, technology, service
- Military history: Strategies/tactics, weaponry
- Social/family mores: Many, many variations with intensely personal and emotional elements
- Political systems: Capitalism vs. socialism, big vs. small government, government leadership vs. self-determination

Dislocations will, without question, continue to occur in the future, and just as surely manifest themselves in unpredictable ways. Survivors, and ideally 'thrivers', will understand when dislocations occur and make the changes necessary to operate well in their new environments.

There are a number of business and societal behaviors that have been culpable in contributing to the interim demise of our socio-economic system:

- Greed
- Poor analysis
- Nonchalance

They are not effective, and have eerie parallels to the 'seven deadly sins'.

While many aspects of our personal and business lives have changed, certain themes remain the same. Righting the ship will be driven by adherence to a number of fundamentals that have driven our success over history and will drive our success in the future.

1) Exhibit responsibility and trust: Our actions … what we say and what we do … are our legacy. Do we stand behind them in terms of honesty and wisdom?

Kahlil Gibran, in his epic work 'The Prophet', said that "You are the bows from which your children as living arrows are sent forth." Quite so, but we need to make sure our aim is straight and sure. Our children are our most sacred trust, the most important manifestations of our legacy. Our actions are right along side in terms of importance.

2) Be 'students' of what we do:

- What is the purpose of our actions? What are we trying to accomplish?
- Are people or institutions going to be hurt by what we are doing?
- What risks are we taking?
- Functions of all kinds … how do they need to be performed?

3) Understand how our products work: What needs and wants do they satisfy? In life insurance, for example, those needs and wants to be satisfied are:

- Protection
- Asset accumulation
- Transactions
- Advice:
  * Our financial world has never been more complicated and uncertain, and customers (both individuals and corporations) have never had a greater need for guidance
  * 'Caveat emptor' (let the buyer beware) - Is this too difficult a burden for the consumer of the 21st century?

4) Focus on what our corporations need to do to succeed:

- Satisfy their customers' needs and wants, more effectively and efficiently than their competitors can

- Manage their profit characteristics well, for themselves and their customers
- Understand the risks in their enterprise, and ensure that they don't interfere with the interests of their stakeholders
- Operate with integrity and transparency

We have recovered from dislocations in the past; we're here, aren't we? Understanding change, that it will always be occurring and how changes have manifested themselves, is critical to our evolution. Not recovery, but evolution. If we forget history, then we are doomed to repeat it. The same is true for understanding history, although the understanding of history is affected by the authors who report it. "How was your vacation?" "I don't know. I have to wait to see the pictures"

We will ultimately solve the major issues confronting our financial system, but in all likelihood will come out of this crisis in a very different place. Where that will be will be forged by our diligent efforts to fix the many egregious dynamics that have caused this crisis as we rebuild our new financial order.