

Wall Street Demons –
Macroeconomics,
Math and Human Behavior

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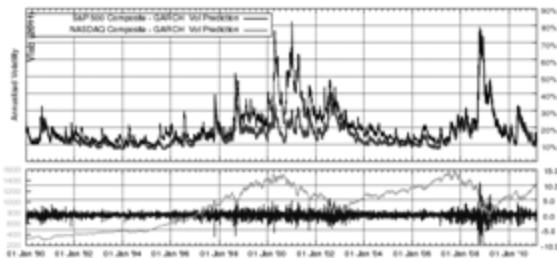
- Moderator
 - Steve Lindo, Director of Treasury Management and Mortgage Risk, Fifth Third Bancorp
- Presenters
 - John Dodson, Director Quantitative Risk Management, Options Clearing Corporation
 - Timur Gok, Visiting Associate Professor & Director, Arditti Center for Risk Management, DePaul University

Contents

- Introduction
- Macroeconomic Policies – The Path to Meltdown
- Behind the Math – Untested Assumptions
- The Human Element - Behavioral Failings

3 Wall Street Demons – Macroeconomics, Math and Human Behavior

Macroeconomic Policies – The Path to Meltdown
John Dodson



4 Wall Street Demons – Macroeconomics, Math and Human Behavior

Behind the Math – Untested Assumptions
Steve Lindo

When, why and how did Wall Street use mathematics?

- The changing of the guard
- Shadow banking dis-intermediated traditional lending
- Mathematization of investment decisions
- Pursuit of profit, not protection from losses

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Behind the Math – Untested Assumptions

Why did the wheels come off the train?

- Perfect storm
- Epidemic of agency conflicts
- Non-traditional uses of math
- No clinical trials

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Behind the Math – Untested Assumptions

What were the most egregious modeling errors?

- Borrowers and investors don't behave like gas molecules
- Standard deviations and correlations break down
- Models failed to capture non-linear outcomes

7

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Behind the Math – Untested Assumptions

What were the most egregious modeling errors?

- Historical time series
- Relative value modeling
- Residential property values
- Model-based debt ratings

8

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Behind the Math – Untested Assumptions

Must there be a sequel?

- Potential measures to curb excesses
 - Reversion to common sense
 - New product safeguards
 - Effective systemic risk management and monitoring
 - Realigning incentives

9

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The Human Element – Behavioral Failings Timur Gök

- Protagonists: The Four Horsemen
 - Greed
 - Hubris
 - Incompetence
 - Malfeasance
- Setting: Fusion of state and private power
- Theme Song: Markets “über alles”
- Extras: Tax payers

10

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Markets “Über Alles”

- “Well, Brooksley, I guess you and I will never agree about fraud,” [Brooksley] Born, in a recent interview, remembers [Alan] Greenspan saying.
- “What is there not to agree on?” Born says she replied.
- “Well, you probably will always believe there should be laws against fraud, and I don’t think there is any need for a law against fraud,” she recalls. Greenspan, Born says, believed the market would take care of itself.

Rick Schmitt, “Prophet and Loss,”
Stanford Magazine (March/April 2009).

11

Financial Crisis Inquiry Commission

- “[P]ublic stewards of our financial system ignored warnings and failed to question, understand and manage evolving risks.”
FCIC Report, Jan. 27, 2011
- No, they did not “ignore warnings and failed to question, ...” They had strong incentives to do so.

12

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Exhibits

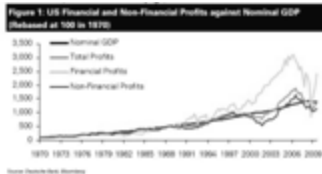
- A. Bear Stearns
- B. Lehman Brothers
- C. AIG
- D. Merrill Lynch
- E. Citibank

Lessons? What Lessons?

“It is difficult to get a man to understand something, when his salary depends upon his not understanding it!”

Upton Sinclair -
I, Candidate for Governor: And How I Got Licked (1935)

Bank Problem in a Single Chart



Questions from the audience

16 Wall Street Demons – Macroeconomics, Math and Human Behavior

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