



A New Book – *Financial Darwinism* - Says Adapt or Face Extinction

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Economic value creation in finance has undergone a fundamental evolutionary transformation, says *Financial Darwinism: Create Value or Self-Destruct in a World of Risk*, a new book by Leo Tilman. Risk has become the dominant factor in how financial institutions create — and destroy — shareholder value. Amid complexity and uncertainty, the book shows, financial institutions must be redesigned in order to adapt to the new financial order and remain competitive.

Financial Darwinism convincingly demonstrates why the demise of the old financial regime was inevitable and why achieving executive, regulatory, public policy, and investment success requires radically new approaches to making strategic decisions.



Leo Tilman is President of L.M. Tilman & Co., a strategic advisory firm that serves governments, financial institutions, corporations, and institutional investors worldwide. Prior to founding the firm, Tilman held senior positions with BlackRock and Bear Stearns, where he was Chief Institutional Strategist and Senior Managing Director. He teaches finance at Columbia University and serves on the advisory board of Columbia's Center on Capitalism and Society as well as on the board of directors of Atlantic Partnership. Tilman was honored by the

World Economic Forum as a Young Global Leader, joining a select group of executives, public figures, and intellectuals recognized for their “professional accomplishments, commitment to society and potential to contribute to shaping the future of the world.”

Robert Huebscher, CEO of Advisor Perspectives, recently sat down with Leo Tilman to discuss the relevance of *Financial Darwinism* to the ongoing financial crisis and to the challenges facing financial institutions, investors, regulators, and policy makers around the world.

In your book, you differentiate between a static “old regime” and the current “dynamic new world.” What are the key differences?

The premise of the book is that nothing short of a tectonic shift has taken place in finance over the last 25 years. During that time, basic financial businesses became commoditized due to globalization, increased



competition, wider availability of information, and other powerful forces. This has resulted in margins and fees of these businesses experiencing a significant compression.

Static business models stand for passive, routine-based behavior of financial institutions and their executives. For instance, banks may take in deposits, turn around and make loans, and passively ride the differential return between the two until maturity. “Borrow at 2 percent, lend at 6 percent, be on the golf course by 3pm.” Sounds easy? Indeed, it has been in the past, when tamer competitive and market environments enabled the luxury of static behavior. In the era of high margins and good fees, financial executives were solely concerned with growing naturally profitable businesses and increasing accounting earnings, so that the stock prices of their firms can achieve high P/E ratios.

Gradually over time, however, financial institutions began to get paid progressively less for doing simple tasks — commercial banking, insurance, investment banking, brokerage, etc. In the spirit of natural selection, many financial firms failed to properly respond to these profound changes in the competitive landscape. By maintaining static behavior, these firms descended into “red oceans” of bloody commoditization and intense competition, subsequently leveraging up and taking on more risk to maintain the same level of profitability.

On the other end of the spectrum were more positive responses to pressures. Successful companies adopted much more dynamic ways of decision making and risk management.

In general, dynamic behavior advocated by *Financial Darwinism* involves visionary transformations of organizations that develop new avenues of delivering returns while properly and actively managing risk.

What role did the Great Moderation play in the transformation between these two regimes?

The Great Moderation denotes the time period between the mid 1980s and today where the volatility of GDP, inflation, and interest rates declined. During this time, the pressures on financial institutions intensified.

Thus, in the context of *Financial Darwinism*, the Great Moderation is not simply a description of the macroeconomic environment. It is an *evolutionary catalyst* that diminished the viability of static, routine-based financial businesses.



In terms of its potency, the Great Moderation was as profound of an evolutionary catalyst as the Great Depression and the Great Inflation of the 1970s, leading to the massive extinction of unprepared financial species. Interestingly, up until the 2007-2008 financial crisis, the Great Moderation was a long evolutionary change characterized by tranquility and record profits. All of this has obscured how stressed the economics of traditional financial service businesses has become.

What are the main challenges faced by financial institutions in the dynamic new regime? What gives rise to competitive advantages at the individual firm level?

First and foremost, the greatest challenge facing financial institutions is to develop the executive level strategic vision reflective of this radically new world. What is the value proposition for a firm in this new environment? Is it to leverage economies of scale in low-margin, commoditized businesses (think of companies like JP Morgan Chase and Bank of America)? Or is to create shareholder value through sophisticated risk-taking and risk management, which is the path of Goldman Sachs and Wells Fargo appeared to be on in the years preceding this crisis.

In terms of differentiating success and failure, I truly believe that it is the strategic vision of executives that has been and will continue to be one of the most critical factors. Helping executives crystallize a strategic vision that properly integrates business and risk activities in a formal and practical way is what *Financial Darwinism* does.

In addition to strategic vision, what is a must in this day and age is what the Nobel Prize winner Edmund Phelps who wrote the Foreword to *Financial Darwinism* calls “systemic knowledge” of financial executives. Systemic knowledge – that includes business acumen and intuition as well as the broad perspective on the macroeconomic, business and market environment – enables financial executives to identify desirable investments, projects, and risks that their firms should take on.

Executives of financial firms that suffered losses and ruin often lacked both the strategic vision and necessary systemic knowledge.

Can you describe the concept of Financial Darwinism and how it helps explain the current credit crisis?

The ongoing financial crisis is a culmination of profound evolutionary changes that came about during the Great Moderation. *Financial*



Darwinism describes this transformation and then points out that financial firms en masse failed to properly respond to evolutionary pressures. The book also identifies the features of the financial landscape that exacerbated this crisis, making its scope and depth truly unprecedented. They included the lack of transparency and complexity of both financial instruments and financial institutions as well as the opaque dissemination of risks around the world due to the capital market globalization.

In addition to explaining how the stage for modern financial crises gets set up, *Financial Darwinism* also puts in perspective the deleveraging stage of the ongoing financial crisis. In the language of the book, everything that is going on today – government bailouts, the Fed actions with respect to monetary policy and liquidity injections, and attempts to stem foreclosures – are actions designed to break the vicious cycle of deleveraging that naturally follows the build-up in risk and leverage. *Financial Darwinism* helps understand how different public policy proposals fit into that paradigm.

Equipped with this evolutionary explanation, the book then proposes a practical decision-making framework that enables companies to become more dynamic with respect to how they take on risk and make business decisions.

Which institutions and CEOs have embraced the strategic imperatives required by the dynamic new regime and are likely to emerge with lasting competitive advantages?

In terms of positive examples discussed in the book, Wells Fargo and Goldman Sachs appeared to have deliberately and properly integrated risk-taking into business decisions over many years, allowing them to weather this crisis reasonably well, at least up until now.

On a different yet important note, this crisis has also revealed the limitations of some business models even for successfully managed companies, showing, for instance, that the business models of commercial banks were more stable than those of independent investment banks. The conversion of Goldman Sachs and Morgan Stanley into bank holding companies is a testament to that.



Were any of the recent financial institution failures the result of not embracing the concepts in your book?

Absolutely. I would argue that practically every one of the notable failures, in some form, was a failure to evolve and respond to pressures in ways that were viable and sustainable.

This crisis seems to claim a new victim every day. There were a number of firms that I described in the book as seemingly following the right path in the spirit of *Financial Darwinism*. However, what is becoming clear is that while Lehman Brothers, Wachovia, AIG, the GSEs were making the right decisions in some parts of their business, they neglected risks in other areas, ultimately paying the price

For example, as described in *Financial Darwinism*, Wachovia was extremely vocal about the firm's objective to gather retail deposits and provide exceptional client service. According to its former CEO, retail deposits were the single most important focus of the institution and source of its profitability. While maximizing the earnings and outreach of Wachovia's retail operations, however, risk management appears to have been overlooked. Some of Wachovia's acquisitions exposed the firm to new significant risks, ultimately leading to problems.

How should financial institutions measure and manage risk in the dynamic new regime?

Sophisticated risk measurement tools and systems that can rigorously assess the risks of portfolios and balance sheets are widely available today. The challenge is to properly integrate them into strategic executive decision-making. Despite advancements in risk management, a significant disconnect between the language of strategic decisions and risk management still exists. This is one of the key limitations of static business models that must be addressed.

You are an advocate of mark-to-market accounting. Opponents argue mark-to-market forces institutions to use artificial and false values for their assets, and it has abetted the practices of short sellers who forced institutions to mark down asset values. What is your defense of mark-to-market?

In a normal market environments, observed market prices can be assumed to be the same as the intrinsic values of financial instruments, so marking-to-market is appropriate in this regard. In stressed environments, however, fire sale market prices may not reflect intrinsic values, which



should be addressed via regulation that accounts for such systemic effects. In times of crisis, financial institutions should be required to mark their holdings to “fair” prices determined in some objectively defined ways. Such a solution is dramatically better than abandoning mark-to-market altogether and going back to accounting standards that tends to obscure the risks taken by financial institutions. Financial Darwinism argues that accounting earnings, standard financial disclosures and credit ratings – all of which are not grounded in modern risk management – have exacerbated the leverage and risk taking in the years preceding this crisis.

What is your forecast for how long the de-leveraging process described in your book will last, and what impact this will have on future market performance?

This remains highly uncertain. The path of the financial crisis from here depends on the macroeconomic environment first and foremost, on how long and deep the worldwide slowdown or recession will be. Secondly, it depends on how successful government intervention will be in breaking the vicious circle of deleveraging described in *Financial Darwinism*.

In that vein, I believe the abandonment of the original purpose of the TARP (buying “toxic” assets from institutions) will be very detrimental. This was the only direct measure that could have brought fire sale prices closer to intrinsic values, and stemmed the de-leveraging process and further write downs. Abandoning this is likely to make the crisis longer and deeper.

In normal times, injecting the capital from the TARP program directly into banks would certainly help the lending environment. But when banks are uncertain how deep the crisis there will be, they won’t lend, exacerbating the impact on the real economy. Some may use the TARP funds for mergers and acquisitions, while others may sit on it as an insurance policy against future losses – with both outcomes defeating the purpose of the bailout.



The nature and extent of government actions during financial crises, the role of systemic regulation, and the future of capitalism, free markets, and globalization – are the topics that are bound to dominate the public debate for years to come. By providing a new evolutionary explanation and a new decision-making paradigm, *Financial Darwinism* hopes to help shape this debate.

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