

## We do know some risks before the fact – not all

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*From Mr Ray Soifer.*

Sir, John Reed (Letters, October 21) cites two “misjudgments” by the financial services industry that contributed to the current “mess”. One, he writes, was to embrace the notion of risk-adjusted capital. “It seems pretty clear,” he says, “that we only know where risks are after the fact.”

Surely this is an overstatement. I doubt that Mr Reed would advocate paying traders based on their gross trading profits, regardless of the risks they assumed, or allocating the same amount of capital to equal-sized portfolios of treasury bills and commercial real estate loans. Yet that is just what many banks did before the widespread adoption of modern risk management. Rather, I might simply suggest we do not know all the risks before the fact, only some. To the capital allocated to these “known unknowns” needs to be added another cushion that addresses “unknown unknowns”.

In his discussion of the other “misjudgment”, placing too much trust in markets rather than institutions, Mr Reed mentions something in passing that deserves further elaboration: the reserves held by banks. Before the 1990s, in addition to their stated capital, banks held two levels of reserves, or “provisions” in UK terminology: specific reserves, covering risks that could be specifically identified, and general reserves, intended to help cover everything else. General reserves, however, were largely done away with after being attacked by accounting bodies and securities regulators as a means of “smoothing” reported earnings.

From the viewpoint of prudential regulation, however, isn’t such a counter-cyclical mechanism just what is needed? Banks topped up their general reserves in good times to use later, when they were needed.

Indeed, while running Citigroup in 1987, Mr Reed did just that, adding \$3bn to reserves and thus pointing the way towards the resolution of the third-world debt crisis.

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