

Compliance has greater role than before crisis, says ex-Lehman head of compliance

July 01 2009 [Alex Davidson](#)

Compliance will have a bigger role than before the financial crisis and needs to recruit from many backgrounds, according to David DeMuro, the former head of compliance and regulation at Lehman Brothers. He said yesterday in a *Complinet* webcast, "The Great Crash of 2008", that faulty risk modelling had been a major factor in the financial crisis and compliance needed to understand this area.

DeMuro said that at Bear Stearns, Lehman Brothers and Merrill Lynch, in particular, there had been a feeling of a need to use the balance sheet a lot, which led to a significant increase in leverage. "When you're in the midst of a bubble, it's hard to stand up and say you should exit it."

DeMuro said that in his role at Lehman, he had access to senior managers. He had flagged that the business model seemed risky, and that securitised products in pools could have a negative impact on institutional clients, and that the firm might have to either substitute mortgages or lose some clients.

According to DeMuro, there was an understanding of risk, but a tremendous faith in models, which was almost a religious comfort. "Beware of maths PhDs in their 20s."

He noted that the Federal Reserve had kept interest rates low so that money would be freely circulated, and that this had not "taken the punchbowl from the party" but had rather added some extra fizz. Others were implicated, however. He noted the policy pressure on Fannie Mae and Freddie Mac to increase mortgages. Nobody, including the Securities and Exchange Commission and the Financial Services Authority, recognised the dangers in the amount of leverage.

According to DeMuro, nobody had anticipated the level of market decline. The typical risk managers of financial institutions looking at models were very bright, and even they missed the problems. He did not find it surprising that regulators had missed them too.

DeMuro noted that European regulators have stated that, as part of Basel II, firms should try to quantify risk, and split it into different types, such as litigation, currency or foreign risk to come up with a risk profile. "Risk managers in financial institutions tended to operate in silos, reporting up to senior management individually, not collectively, so there was no free flow of information to assess overall risks. There should be a protocol where risk managers meet together."

He said that risk managers operating in silos were "excellent in a narrow area" but might miss the main event "outside the silo".

Compensation structures

According to DeMuro, executive compensation structures were a convenient scapegoat. "They were not a significant or major cause of the crisis." He noted that at Lehman, employees had owned one third of company stock. A significant amount of institutions' compensation was made up of deferred stock to align the interests of individuals and institutions. "Those amounts were significant, coming in many cases to half of the compensation over five years. The cash component made us comfortable, but the deferred stock element had the potential to make us wealthy."

DeMuro could not identify a single acorn that grew into the oak tree of the crash but said that securitisation of mortgages had not in itself been a bad idea. The problem had been that, as happened in bubbles, standards slip — as in sub-prime when people could borrow at teaser rates.

When asked what he would have done differently pre-financial crisis at Lehman, DeMuro said that he would have sold his stock earlier, and would have been louder about his concerns. "I don't think it would have really made a difference but I'd have been, not a Cassandra, but more vocal."

DeMuro said that there was a lot more tension in compliance post-financial crisis. "There's an understanding that learning how to control risk is important for the wellbeing of financial institutions. Compliance will be given a bigger role than previously."

At the same time, he noted that there had been a significant number of job losses in the compliance space, as there had been elsewhere. "Most financial institutions in the last year would say that staffing levels were lower."

DeMuro said that compliance officers now had to speak the language of people in other areas of the business such as operations, and need to understand the products, and their

downsides, as well as risk and modelling. He said that as much as he loved lawyers — and indeed was one himself — the compliance profession needed a mix of skills as well as a culture where people were rewarded for raising questions.

He said: "There needs to be a culture to protect people and the institution, and to raise concerns and problems. I can't think of a single issue that affected a financial institution that couldn't have been detected earlier if questions had been asked."

He said that he was always concerned when people tried to suspend the laws of gravity. Advice he used to give people, and he would still give, was when there was talk of a new paradigm, to go for the nearest exit.

Professional standards

According to DeMuro, it would be useful to recruit experienced as well as new people into the compliance profession. "It's useful to have different points of view, life experiences, job experiences, but [the mix of people] should be tempered with people with institutional memories."

DeMuro said that he had spent a lot of time reading the last 80 pages of the white paper of the Obama administration. He noted that the plan had called for the Federal Reserve to have primary responsibility for larger financial institutions with systemic impact on the economy, and that those organisations would have high capital requirements. He said that this would be beneficial but that he did not know whether such a measure, if taken earlier, could have headed off the financial crisis.

He said that in the white paper there was some missed opportunity, including that the Commodity Futures Trading Commission and the SEC would continue to operate separately. "The US is the only major financial market that has not combined futures and securities regulation."

He said that compliance people would have to act within the realm of what the institution could afford, given that institutions were smaller now, and that balance sheets were smaller. Firms should not, however, make market conditions an excuse to scale back risk management.

DeMuro said that there would be a big change in regulation. He noted that the FSA's chief executive, Hector Sants, said that people should be very afraid of the FSA. Government regulation would be more intrusive and the regulators would approach the industry with scepticism, following the Madoff scandal and the fallout from 2008. More attention would

be paid to global standards, including in accounting.

He concluded that compliance remained, in his view, a fascinating business to be in. In 10, 20 or 30 years from now, compliance officers would be able to say to younger colleagues that what was happening at the time was nothing compared with what had happened in 2008.