Bystanders to this financial crime were many

By Nassim Nicholas Taleb and Pablo Triana
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On March 13 1964, Catherine Genovese was murdered in the Queens borough of New York City. She was about to enter her apartment building at about 3am when she was stabbed and later raped by Winston Moseley. Moseley stole $50 from Genovese's wallet and left her to die in the hallway.

Shocking as these details surely are, the lasting impact of the story may lie elsewhere. For plenty of people reportedly witnessed the attack, yet no one did much about it. Not one of the almost 40 neighbours who were said to have been aware of the incident left their apartments to go to Genovese's rescue.

Not surprisingly, the Genovese case earned the interest of social psychologists, who developed the theory of the "bystander effect". This claimed to show how the apathy of the masses can prevent the salvation of a victim. Psychologists concluded that, for a variety of reasons, the larger the number of observing bystanders, the lower the chances that the crime may be averted.

We have just witnessed a similar phenomenon in the financial markets. A crime has been committed. Yes, we insist, a crime. There is a victim (the helpless retirees, taxpayers funding losses, perhaps even capitalism and free society). There were plenty of bystanders. And there was a robbery (overcompensated bankers who got fat bonuses hiding risks; overpaid quantitative risk managers selling patently bogus methods).

Let us start with the bystander. Almost everyone in risk management knew that quantitative methods – like those used to measure and forecast exposures, value complex derivatives and assign credit ratings – did not work and could provide undue comfort by hiding risks. Few people would agree that the illusion of knowledge is a good thing. Almost everyone would accept that the failure in 1998 of Long Term Capital Management discredited the quantitative methods of the Nobel economists involved with it (Robert Merton and Myron Scholes) and their school of thought called "modern finance". LTCM was just one in hundreds of such episodes.

Yet a method heavily grounded on those same quantitative and theoretical principles, called Value at Risk, continued to be widely used. It was this that was to blame for the crisis. Listening to us, risk management practitioners would often agree on every point. But they elected to take part in the system and to play bystanders. They tried to explain away their decision to partake in the vast diffusion of responsibility: "Lehman Brothers and Morgan Stanley use the model" or "it is on the CFA exam" or, the most potent argument, "modern finance and portfolio theory got Nobels". Indeed, the same Nobel economists who helped blow up the system at least once, Professors Scholes and Merton, could be seen lecturing us on risk management, to the ire of one of the authors of this article. Most poignantly, the police itself may have participated in the murder. The regulators were using the same arguments. They, too, were responsible.

So how can we displace a fraud? Not by preaching nor by rational argument (believe us, we tried). Not by evidence. Risk methods that failed dramatically in the real world continue to be taught to students in business schools, where professors never lose tenure for the misapplications of those methods. As we are writing these lines, close to 100,000 MBAs are still learning portfolio theory – it is uniformly on the programme for next semester. An airline company would ground the aircraft and investigate after the crash – universities would put more aircraft in the skies, crash after crash. The fraud can be displaced only by shaming people, by boycotting the orthodox financial economics establishment and the institutions that allowed this to happen.

Bystanders are not harmless. They cause others to be bystanders. So when you see a quantitative "expert", shout for help, call for his disgrace, make him accountable. Do not let him hide behind the diffusion of responsibility. Ask for the drastic overhaul of business schools (and stop giving funding). Ask for the Nobel prize in economics to be withdrawn from the authors of these theories, as the Nobel's credibility can be extremely harmful. Boycott professional associations that give certificates in financial analysis that promoted these methods. Remove Value-at-Risk books from the shelves – quickly. Do not be afraid for your reputation. Please act now. Do not just walk by. Remember the scriptures: "Thou shalt not follow a multitude to do evil."

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