The Old City Had It Right

Contributed by Martin Hutchinson
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Forty-two months after the collapse of Lehman Brothers, negative banking stories continue appearing daily – not about the criminal prosecutions for events that happened five years ago, but on examples of greed and stupidity that are occurring today. On both sides of the Atlantic, massive regulatory efforts have been carried out that, if anything, have made matters worse. Nobody has confidence that another Lehman Brothers, with accompanying taxpayer rescue of major banks, could not happen next month.

Let’s face it: the current financial system simply does not work. It concentrates risk in the largest institutions, which have to be bailed out, it prevents management from being held to account for its misdeeds, it promotes sharp-elbowed “investment bankers” to run behemoths most of whose business is entirely routine and it makes shareholders a despised peon class whose dividends are subordinated to the stock options of its management. As I suggested a couple of weeks ago, financial services as a business may be about to decline back to its historic share of the economy; it seems clear from recent events that it will have to be restructured also.

The leaving letter by Greg Smith to his ex-employer Goldman Sachs, published March 14 in the New York Times, identifies some but not all of the problems. His claim that Goldman no longer puts clients’ interests first would certainly appear valid, from published information. However his timing on when that change occurred, allegedly within his mere decade at the firm, is laughably off-track; Goldman Sachs was run by Jon Corzine, of later MF Global notoriety, from 1994 to 1999, before Smith joined, and it had certainly become a trading-oriented client-exploiting behemoth by then.

The key piece of evidence is Lisa Endlich’s book, Goldman Sachs: The Culture of Success, published in 1999. It’s full of snide comments about how feeble and hidebound the old corporate finance guys were and how, beginning in the late 1980s, she and her trading colleagues took over the firm and remade it in their own image. It was always clear to me, reading the book when it was published, nearly a decade before the 2008 crash, that Endlich’s “feeble and hidebound” was pretty accurate code for the ethical, client-oriented values that Goldman progressively lost from about the mid 1980s, and that had been fully replaced by the trading-oriented culture by the time of Endlich’s book and Goldman’s 1999 flotation. In that respect however, Goldman was by no means unique; its trajectory was more visible because of Goldman’s outstanding success, but other houses followed the same unhappy route (or like the late unlamented Salomon Brothers, were never client-oriented in the first place).

The central problem of the current financial system is that the heavy blocks of capital necessary for nationwide commercial banking and insurance are given to speculators to play with. That was in retrospect the central virtue of the Glass-Steagall legislation separating commercial and investment banking; it ensured that the depositors’ funds and the capital generated by a commercial banking operation of the size of Citicorp or Chase Manhattan were used almost entirely for relatively low-risk commercial banking (although as Walter “Countries can’t go bust” Wriston of Citicorp demonstrated, foolish megalomania still got them in trouble from time to time).

Trading operations, along with brokerage and corporate finance, were then segregated in much smaller organizations, at that time owned directly by their partners, with unlimited liability. These trading, brokerage and corporate finance operations differed significantly from each other (Salomon Brothers had little corporate finance activity, relative to its size, while Morgan Stanley and Kuhn Loeb did very little trading until the 1970s). Nevertheless they were in no sense “too big to fail.”

When a sharp downturn in stock exchange trading activity combined with a horrendous back-office crisis to send several of the largest investment banks hurtling into bankruptcy in 1970, there was no question of a state bailout – that was reserved for such more serious bankruptcies as the railroad Penn Central. The role of the $700 billion TARP public slush fund was played by the Texas multimillionaire (not then a billionaire) Ross Perot, who took over the bankrupt brokerage Glore Forgan & Co., and expertly managed it into renewed bankruptcy four years later.

The romantic dream by which opponents of Glass-Steagall drove the political campaign to repeal it, which eventually succeeded in 1999, was inspired by a vision of the old J.P. Morgan bank, which had bestrode the financial world like a colossus, bailing out both the U.S. government in 1895 and the British government in 1915. However that dream – a full service universal bank, among the largest financial institutions, offering both commercial banking and investment banking services and driven by a titan of finance – was already outdated by 1914. It relied on the supreme genius of Morgan himself, and after his death in 1913 gradually lost its primacy to more aggressive (and alas, less ethical and competent) competitors before being split by Glass-Steagall in 1935.

The 1933-1975 U.S. financial system was highly imperfect; it relied on heavy regulation (of deposit interest rates, in the case of commercial banks and of commissions, in the case of brokerages). It included commercial banks that were too aggressive for their ecological niche and investment banks that had very little interest in international business, since they had been burned badly by the aftermath of the 1920s foreign bond bubble and could make a very nice living through domestic brokerage and underwriting alone.

The better model was that operating in London before 1986. There commercial banks were truly dozy operations, whose upper management consisted of modestly intellectually endowed long-timers with a taste for golf. Brokerage was a separate operation, as was market-making, both organized in thinly-capitalized partnerships with unlimited liability. As with the New York investment banks, risk was limited by the wishes of the partners to preserve their retirement savings, but the London system recognized the fact that the talents for brokerage (salesmanship) and market-making (nerves of steel and a head for figures) were neither necessary nor desirable in the commanding heights of the financial system.

That peak was occupied by the London merchant banks, which being 200 years old had high prestige and standing, and thus attracted the best graduates and were able to talk to titans of industry on equal or even slightly superior terms, in spite of their modest capitalization. The underwriting function was arranged by the merchant banks, but was carried out by insurance companies, pension funds and investment institutions, well suited by their capital to take the modest risks involved. The system was in its original pre-1914 form completely global (less so afterwards, because of British exchange controls), since advisory and underwriting work for foreign clients required only very limited (albeit extremely impressive) staffing at the client end, with the actual work being carried out in London and sales being made through the brokerages, underwritten by the institutions. Add the Accepting Houses Committee, a merchant bank club formed in 1914 which enforced industry standards of probity and sorted out competitive squabbles, and you have a financial system that worked very well indeed.

Government errors brought down the London system. Exchange controls effectively prevented cross-border investment for forty years from 1939, limiting the merchant banks’ ability to compete internationally, although by the 1960s they had recovered considerably. The World Bank and the IMF took away the merchant banks’ emerging markets advisory business, and did it incomparably worse. Ludicrous, unbelievably evil levels of individual tax combined with high inflation to de-capitalize the system, especially the jobbers, who became unable to fulfill their market-making function properly (and in any case were unable to operate internationally because of exchange controls). Then, after a decade in which the merchant banks and jobbers had been reduced to international midgets by tax and inflation, the Thatcher government foolishly imposed a “level playing field” – and the result was painful and not very edifying history.

To those who protest that the derivatives market and its offshoots have all come into existence since 1980, and make the trading-oriented behemoths essential, I would respond that the economic value of those markets, other than as rent-seeking exercises, is in most case pretty marginal, and that their needs should not be allowed to drive the financial system. We now have hedge funds, full of aggressive, incentivized traders willing to take on any kinds of risks; the derivatives markets can thus be left safely in their hands. In any case, once interest rates are restored to their proper levels and proper legislation (or a modest Tobin tax) is brought in to curb insider trading (algorithmic or otherwise) based on knowledge of market flows, volumes in these markets are likely to decline.

Investment institutions have repeatedly expressed their view that a large part of their assets should be devoted to “alternative investments” – normally hedge funds and private equity funds with outsize fees attached. Very well, let their money be devoted to propping up the derivatives and other trading markets, so that they are not attached to the massive pools of capital needed for banking and conventional insurance. If the hedge funds go bust, so that a few Harvard students have to pay their own way, a few California state pensioners find their pensions reduced; well, them’s the breaks. There is no reason why those costs should be paid by bank depositors or by taxpayers as a whole.

The seeds of a new financial system are already here, in the medium sized “boutiques” such as Greenhill and Evercore, whose client orientation is less sullied by their trading desks. Among commercial banks, those such as Barclays and Deutsche, where the investment banker/trader inmates have taken over the heavily capitalized asylum, are already looking like ineffective dinosaurs and will doubtless shortly go spectacularly bust. To replace them will come a new generation of pure commercial banks, such as Wells Fargo and PNC Corporation, far more capable than their competitors in their large low-risk niche, and content to avoid the perils of investment banking – and the unpleasantness of hyper-greedy investment banker colleagues.

Nothing will ever replace the sublime glory of merchant bank dining rooms. But the remainder of the pre-1986 London structure looks very much like the best way forward for the global financial system as a whole.

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