The Wall Street Of The Future

by Martin Hutchinson Monday, 01 December 2008 15:13

Two weeks ago, the stock market finally returned to its valuation levels of before the monetary bubble began in 1995, appropriately inflated for the rise in nominal Gross Domestic Product. The 4,000 on the Dow Jones index that was first reached within a week of Alan Greenspan's February 23, 1995 Humphrey-Hawkins testimony loosening monetary policy is equivalent to about 7,900 today; on November 20 the market closed below that valuation level for the first time in over 13 years. We are thus in a new world; it is thus time to determine a structure for Wall Street that will make the new order one of economic growth led by technological and business methods innovation, with finance playing its appropriate supporting and enabling role. Last week I anatomized the failings of Wall Street during the 1995-2008 bubble; today I want to look at how it might be restructured.

We cannot look at the new Wall Street structure from the position of an omniscient deity trying to create the perfect financial system, because such a position is not currently available. Instead we must examine it from the point of view of what can be achieved in practice either by the market or by finite and plausible regulation. By monetary and fiscal policy, market conditions can be usefully affected, pushing institutional behavior patterns in the right direction. On top of that, well chosen regulation can prevent abuses during the course of bubbles, although tight monetary policy will do most of the work here.

The downturn itself has caused major institutional changes. Whereas previously very large banks were thought to be probably "too big to fail" there was no certainty about it. Furthermore, the most important role in corporate finance was played by the investment banks, about which no such assumption then existed. Today there are no large investment banks and very large financial institutions in general have shown themselves both vulnerable to failure and entitled to a government bailout if failure occurs. Hence even if we wanted to return to the 1995-2008 version of Wall Street, we couldn't.

The first problem to be solved is what to do with institutions that are "too large to fail." Clearly they must not be permitted to leverage themselves as did the banks and investment banks of the bubble years, nor must they be allowed to do "fat tail" high-risk principal trading, nor to invest more than modestly in private equity and other illiquid and risky securities. Equally, there is a place for institutions on which the public can unconditionally rely in taking deposits, making loans and underwriting low and moderate-risk securities.

The large banks will respond that through their sophisticated risk management systems they can protect themselves and the taxpaying public against loss. They should not be believed. The current crisis has shown that not only did the Value At Risk risk management system pathetically fail, there is no risk management system that is capable of controlling complex instruments in a turbulent market. While the market remains calm as it did from 1995-2007, these securities' behavior remains apparently under control, obeying the VAR risk limits in most cases and deviating from them only modestly in the 1% of cases they fall outside their VAR limits. However in turbulent markets, as we entered for mortgage securities in July 2007 and for all securities in September 2008 there is no limit as to where these securities may trade. The problem is exacerbated by "mark to market" accounting, which forces entities to mark exotic securities to their value in a thin secondary market, no matter what their likely long term risk characteristics.

Hence "too big to fail" institutions should not be allowed to have more than a modest portion of their capital (say 1/3, an amount they can afford to lose and survive) in risky or highly illiquid instruments. In return, "mark to market" accounting should be abolished for these institutions. There are essentially public utilities, like the local water company, and should be regulated and controlled as such. They will do big deals, and will have a limited underwriting capability, but they will not be centers of either risk or innovation. Their staff will be generally bureaucratic in nature, and paid accordingly, although clearly there will be some modestly challenging management positions at the top.

The "too big to fail" institutions will include the national commercial banks,

Fannie Mae and Freddie Mac (whose leverage will be severely limited). They will benefit enormously from their paper being essentially government guaranteed, but will be engaged almost entirely in low-margin commoditized businesses, and their leverage will also be strictly limited. They will also be highly regulated.

There will also be three other categories of institutions, each of which will have limits on their total assets so as not to become a threat to the financial system if they fail. Their borrowing costs will be greater than the "too big to fail" banks but they will benefit from being less restricted and, if they wish, higher leveraged.

The first will be the advisory houses, sources of most financial innovation and advisory work for major corporations on mergers, fundraising and other matters. They will be private partnerships with unlimited liability and therefore of necessity modestly capitalized and able to take only modest principal risks. They will arrange underwritings, but will subcontract the underwriting risk to the "too big to fail" institutions and to other investment institutions. Their remuneration for a new issue will thus primarily be a management fee. They will be lightly regulated, since the partnership form should make them largely self-regulating; in any case they will not be "too big to fail." In general, they will employ the most capable people.

The second category of smaller institutions will be those with a primarily local business, particularly in the field of home mortgages. Since these will not be "too big to fail" they should be allowed to carry on more or less as at present, with deposit insurance and a limit on their size. Having higher funding costs but fewer restrictions than the "too big to fail" houses they should be competitive with them in serving their local areas. Certain modern financial techniques, notably interest rate swaps, will enable them to hedge their risk of lending long and borrowing short.

Finally, there will be investment institutions themselves, which will include insurance companies, pension funds, hedge funds and private equity funds. These will have the choice of obeying the size restrictions to avoid "too big to fail" in which case they will operate freely, or growing larger, in which case they will be restricted as to the amount of their funds under management they can invest in illiquid or otherwise risky assets, and the leverage they can take on. They would retain the "mark to market" accounting regulations for their accounts. The modest hedge fund and private equity fund sectors would be homes for people with a high level of ability and an equivalent level of greed/aggression; such people would thus be safely segregated from the advisory business and the levers of real financial power.

As to business areas themselves, there would appear to be two further necessary restrictions beyond those which already exist. First, credit default swaps should only be legal if traded over an exchange; the exchange would then establish rules as to collateral etc. and publish records of positions taken. Second, loans would only be securitizable by their originator for up to 80% of the originator's participation in them (so 20% would remain on his books) and artificial securitizations that were not tied to a particular loan would be prohibited. Thus a manager who took $100 million of a $1 billion loan syndication would be able to securitize $80 million but would have to keep $20 million; similarly the originator of a $500,000 home mortgage would have to keep $100,000. Naturally "too big to fail" institutions would be subject to capital limitations on their derivatives businesses and loan securitization positions.

This structure would be implemented by a combination of three methods. First, legislation would be passed tightly restricting the activities and leverage of "too big to fail" institutions. That would drive the best talent outside those institutions, either to hedge funds or advisory partnerships. Second, legislation would tightly restrict conflicts of interest for advisors in underwritings or merger transactions, basically prohibiting them from taking more than small participations in deals they arranged. Some thought needs to be given as to how to push the advisory entities into the private partnership form which is optimal from a public policy perspective. Maybe particularly onerous Sarbanes-Oxley type disclosure and auditing regulations on them as public companies would be appropriate, or maybe "mark to market" accounting itself would be sufficiently onerous for advisory companies as to discourage public listings.

Finally a tight monetary policy would radically change the environment in which Wall Street operates. The speculation and over-leveraging of the bubble years was greatly exacerbated by the lengthy persistence of "easy money"

conditions. By 2007, the first stirrings of the downturn were described by the Bear Stearns chief financial officer as “the worst I’ve ever seen in 22 years” – technically quite correct, as he had only entered the business in 1985. Easy-money markets that last longer than senior management’s career lengths are a serious menace to financial system health. The solution is tighter money – which reduces the length of bubbles to no more than a few years – and more experienced senior management, eliminating the “drop-dead money by 40” syndrome that bedeviled Wall Street during the bubble years. In the 1987 crash, Kidder Peabody’s chairman was Al Gordon, who had got his start on Wall Street in 1925 and was a full partner before the1929 Crash; a properly run financial services industry contains a substantial leaven of such people at the very top.

A reformed financial services business will play a smaller role in the US and global economies, and will be only one of a number of attractive career alternatives for the best and brightest. It will greatly contribute to the health of the US economy as a whole, in particular sharply reducing the percentage of the nation’s assets that are controlled by crooked or incompetent short-term operators. It’s not that difficult to implement; just a tight monetary policy and one carefully crafted piece of legislation should be sufficient. Now, while the industry is chastened by failure, is the time to arrange its restructuring.

(The Bear's Lair is a weekly column that is intended to appear each Monday, an appropriately gloomy day of the week. Its rationale is that, in the long '90s boom, the proportion of "sell" recommendations put out by Wall Street houses declined from 9 percent of all research reports to 1 percent and has only modestly rebounded since. Accordingly, investors have an excess of positive information and very little negative information. The column thus takes the ursine view of life and the market, in the hope that it may be usefully different from what investors see elsewhere.)

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