Economist.com SPECIAL REPORTS

How to play chicken and lose

Jan 22nd 2009
From The Economist print edition

Finance suffers from reverse natural selection

Illustration by S. Kambayashi

THE great American economist Irving Fisher was never able to live down his remark, just before the 1929 crash, that share prices had reached what seemed "a permanently high plateau". Fisher's shoes have been filled by Chuck Prince. "As long as the music is playing," the then head of Citigroup told the *Financial Times* just weeks before the credit markets seized up in August 2007, "you've got to get up and dance." Then he uttered his fatal coda: "We're still dancing."

It was a silly thing to say. Before the year was out Mr Prince had resigned over Citi's losses. But it was not a silly thing to believe. In financial services, wallflowers are losers. A bank of Citi's size cannot sit out the boom without confronting commentators and investors alike. The winner is more likely to be the bank that dances in the hope that it can scramble to a seat when the music stops (even if, as in this crisis, there are virtually no seats).

Financial services will always be a tug-of-war between two contradictory promises: "Your money is safe with us" and "We will earn you higher returns." The disturbing truth behind Mr Prince's words is that bit by bit a boom kills off those who tend towards safety. The survivors, meanwhile, go for returns, because as long as the sky is clear financial-services companies grow by earning money.

Since the 1970s Wall Street's tug-of-war has grown fiercer. The industry in America—and hence in the City of London, Frankfurt and Paris—has evolved from a guild of small partnerships trading in semi-rigged markets into a joust of giant multinationals and clashing egos. Competition has led to innovation and lower charges. It has increased the supply of credit, which boosts economic growth. But the job of managing financial-services powerhouses—keeping people's money safe as well as making a good return—has become harder than ever.

The good old days

In 1970 Goldman Sachs had about 1,300 people. At the end of last year it had roughly 30,000. In 1971 Morgan Stanley had about 3,500 people; at the peak, in 2006, it had 55,000. Although boutiques such as

Perella Weinberg have sprung up in the intervening period, the story of commercial and investment banking has been broadly one of consolidation.

Roy Smith, a finance professor at NYU Stern School of Business in Manhattan, has counted no fewer than 28 takeovers of once-important commercial and investment banks since 1977. Kuhn Loeb, White Weld and Donaldson, Lufkin & Jenrette have all disappeared, as have Solomon Brothers, First Boston and Kidder Peabody. Firms also built up their capacity to trade in the secondary market, at first so they could make markets and later to earn profits on their own account. As the demand for capital grew, the partnerships were tempted to list their shares. The old Wall Street was lost.

It would be a mistake to idealise the partnerships. Samuel Hayes, of Harvard Business School, points out that after the second world war the fees for many operations were fixed. Underwriting syndicates for raising capital were predetermined for each client. If a minor but ambitious firm like Salomon Brothers tried to by-pass the managing underwriter and go direct to a client, the underwriter would ostracise it and give it a bad name on Wall Street. Managed competition gave the firms an incentive to regulate themselves. Future profits depended on the status quo, which had to be protected. That produced stability, but at what cost to clients?

On the other hand, partnerships really were easier to run, because the firms were small and their business was straightforward. To the critics of modern-day investment banking, their virtue lay in the fact that their senior managers were also their owners. They were not gambling with shareholders' money.

The argument is that managers in recent times took excessive risks because they did not own their firms. Moreover, their pay gave them huge incentives to gamble with the business. In "Liar's Poker", his tale of Salomon Brothers in the 1980s, Michael Lewis records the words of a senior trader who worked for Lew Ranieri, the creator of mortgage-backed securities: "At other places management says, 'Well, gee, fellas, do we really want to bet the ranch on this deal?' Lewie was not only willing to bet the ranch, he was willing to hire people and let them bet the ranch too. His attitude was: 'Sure, what the fuck, it's only a ranch'."

In fact, the argument about ownership and pay is not entirely convincing. It is true that pay was large—far too large, it is clear, now that so many of the profits bankers earned in the bountiful years have turned out to be illusory. But a bubble that inflated revenues, share prices, fees, profits and employment was bound to inflate pay too. By the same logic, today's bust will lower it.

The incentives were more complex than to bilk shareholders by betting the ranch every time. Managers at Bear Stearns and Lehman Brothers were not partners, but they still owned large slugs of the business. Jimmy Cayne, Bear's chief executive, personally lost more than $1 billion in its collapse; Dick Fuld, his counterpart at Lehman, is believed to have lost a similar amount. Although traders are overwhelmingly paid in cash, the managers who are supposed to oversee them take about half their bonuses in share options and shares that they are not allowed to sell for three to four years. Many outfits frowned on employees selling shares even when they were formally allowed to do so. After only a few years at a bank, most managers would have a large part of their wealth tied up in the firm's survival.

The end of partnerships turned private rivalries into a public tournament. The senior managers' wealth, careers and status were completely wrapped up in their firms' pre-eminence. League tables, quarterly results, daily share-price movements, total shareholder returns, all are ways of keeping score of who is up and who is down. If you did not compete, you were a dullard. If you pulled back, your career might be cut short. Not for nothing did they call the conservative Brown Brothers Harriman, the grandest remaining partnership, "the cemetery with the lights on".

Rather than being victims, shareholders may well have driven managers on. Hans-Werner Sinn, the head of Ifo, an economic research institute in Munich, argues that limited liability gives them a reason to flirt with disaster. The creditors of a failed firm have no claim on the personal assets of its shareholders. So if the bank takes big risks that promise big profits, its shareholders stand to enjoy the full gains but to bear only part of the losses. By contrast the shareholders of low-risk, low-return banks that never collapse have to bear all the losses.

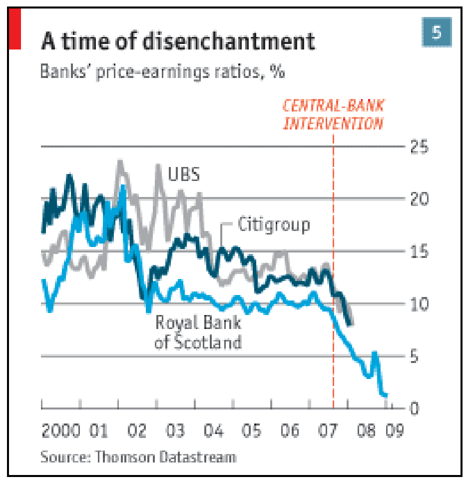
George Gilbert Williams, long-time head of Chemical Bank in New York in the 19th century, once explained that his success was founded on "the fear of God". But as a boom takes its course, fear is supplanted in what a senior quant at an American bank calls the "Cassandra effect". The more you warn your colleagues about the tail risks—the rare but devastating events that can bring the bank down—the more they roll their eyes, give a yawn and change the subject. This eventually leads to self-censorship. "The system", he says, "filters out the thoughtful and replaces them with the faithful."

Unwelcome advice

Models might look objective, but each has its own context—to make a sale, bear down on an impulsive trader and so forth. Andrew Lo, a professor at the MIT Sloan School of Management, imagines a confrontation in 2004 between the head of Lehman and its chief risk officer. Foreseeing a catastrophe ahead, the risk officer proposes shutting down the mortgage business, but his boss threatens to sack him on the spot. He suggests cutting back, but the boss counters that his competitors are expanding and his best people would be poached. He mentions hedging the risk, but his boss retorts that in the next two years that will cost hundreds of millions of dollars in lost profits.

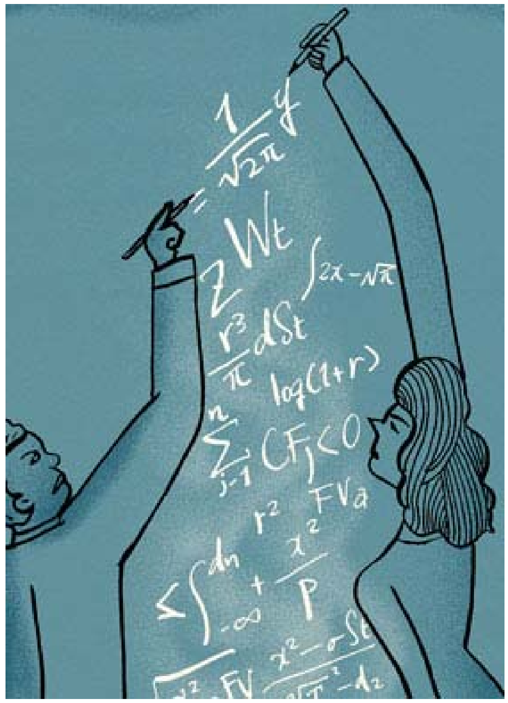
The risk officer's analysis would be hard for all but partnerships, private companies and Warren Buffett to follow (and even the veteran investor's reputation was tarnished when he sat out the dotcom boom). To paraphrase Keynes, if you work in finance the market can stay irrational longer than you can stay in your job.

As managers built financial conglomerates and sought to push them ever harder, the quality of earnings in their industry was deteriorating (see chart 5). Most of the large outfits have struggled to create an *esprit de corps*. Alan Johnson, a pay consultant who specialises in finance, describes a trading room of, say, 1,000 people. Fifty of them might be over 40 years old and just ten over 50. Their typical career might peak after five to seven years. Charles Ellis, author of the recent book on Goldman, thinks traders' focus has narrowed as rewards have gradually shifted from the team and the year to the trader and the individual trade. People may well not know, understand or care about the business of the traders on the next desk. Mr Ellis thinks that the sorts of people who go into finance these days are different from their predecessors—more transactional, cleverer and less strategic.



Sometimes the top brass mismanaged the detail. According to Mr Derman, rivals copied innovations within months, so the arms race in modelling tended to lead to complexity, because you could charge more for it and because complexity is harder to reverse-engineer. Yet complexity can be dangerous. Citigroup came a cropper when it sold "liquidity puts" along with its CDOs. These gave the buyers the right to hand the CDO back at the original price if the market collapsed. They looked like a tweak that would enable the bank to extract a slightly higher return, and Citi's most senior managers knew nothing about them. The liquidity puts ended up costing the bank a king's ransom when $25 billion-worth of CDOs came back on to the balance sheet.

Illustration by S. Kambayashi



But the strategy too was sometimes poorly handled. It started perfectly well in the 1970s with Walter Wriston at First National City Bank, later renamed Citicorp. Wriston trained an entire generation of bankers who wanted to make better use of their capital and to grow faster. More recently, commercial and investment bankers have contracted a bad case of Goldman envy. As a result, senior managers have demanded double-digit increases in sales and profits year in, year out (rather as investors, stricken with Yale envy, sought to match the returns of the university's endowment fund by pouring money into private-equity and hedge funds). Stern's Mr Smith points out that the growth imperative required volumes for each product to be big, as they were in mortgage-backed securities and leveraged loans. Some of the worst mistakes befell banks like Citi, UBS and Merrill Lynch which were told from on high to catch up in mortgage finance. Woe betide any banker who fell behind.

An internal investigation into $38 billion of mortgage losses at UBS, ordered by the Swiss Federal Banking Commission, blamed the disaster on a push for growth in the bank's fixed-income business. The CDO desk piled into "mezzanine" tranches of the securities, which paid more but ultimately lost more too. At its peak the CDO desk had only 35-40 people, but it amassed around $12 billion of write-downs in 2007, two-thirds of that year's total.

Over the past 35 years it has seemed as if everyone in finance has wanted to be someone else. Hedge funds and private equity wanted to be as cool as a dotcom. Goldman Sachs wanted to be as smart as a hedge fund. The other investment banks wanted to be as profitable as Goldman Sachs. America's retail banks wanted to be as cutting-edge as investment banks. And European banks wanted to be as aggressive as American banks. They all ended up wishing they could be back precisely where they started.