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# FINANCIAL NEWS



## Reshaping the banks has only just begun

Roy C Smith

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**The US media has been buzzing with reviews and comments about William D Cohan's new 670-page blockbuster *Money and Power, How Goldman Sachs Came to Rule the World*, his third Wall Street "history" in just three years.**



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Charles D Ellis spent 10 years writing *The Partnership*, his much praised 2008 effort to capture the "culture" of Goldman Sachs, and so Cohan's latest effort seems a rush job to catch the last of the lingering public rage against the big banks that played so rough during the financial crisis.

Cohan interviewed former senior partners, who turned out to be much more loquacious than expected for a firm known for its secretive ways.

The glitzy New York version in *Vanity Fair* included a lengthy, pre-publication excerpt covering 1989-1999 when the firm had five chief executives. This was truly a messy period in the firm's history, full of juicy bits for gossips to savour.

But the piece never mentioned that these were very difficult times in both Wall Street and the City of London, when firms changed their business models drastically to survive and a great many

distinguished names either failed or disappeared into mistaken or unwanted mergers.

Goldman is one firm that sailed through this period, despite its management changes and other tumultuous events, without slowing down much at all. Indeed, it emerged after its initial public offering in 1999 as the unquestioned leader of the global capital markets industry.

The real story of the investment banks began in the mid-1960s when markets suddenly became large, institutionalised and competitive. There were then about 20 significant American investment banks and 10 or so UK merchant banks that dominated the markets.

But these were greatly shaken up by continuing waves of deregulation that encouraged market development and further increased competition. Commissions were cut drastically and firms dependent on brokerage revenues were forced to look for higher ground.

Then came a wave of globalisation as market forces ended the Bretton Woods era of fixed exchange rates, and liberalisation extended to removing exchange controls, encouraged the birth of the Euromarkets, modernised national European financial markets and redirected Europe into the European Union. Then came privatisations, more open markets, freer cross-border competition, and the Economic and Monetary Union.

To all this was added the accelerating effect of extraordinary developments in computer and telecoms technology that enabled securitisation, derivatives and complex synthetic products, while making market information available and actionable anywhere, anytime.

Financial markets soon became cut-throat – clients were offered low-rate financial deals from all over the world – and long-time relationships rapidly faded in importance as price-conscious clients put mandates up for auction.

Then in 1999, the Glass-Steagall Act was repealed, driving the largest US banks into capital markets, forcing their European counterparts to keep up. The race was on to build the biggest balance sheets to absorb client risk, make markets and trade a bit on their own.

Whether or not banks were good at trading, understood its flows and risks and how to manage them, to be in the game they had to trade. Management and advisory fees dropped precipitously as a percentage of total income and trading revenues soared. It became a tough environment in which “you ate what you killed”, as many bankers described it.

Firms became bigger, braver, more innovative and intense. All the added competition meant users of capital were getting great deals – competition was driving cost of capital down, though at the expense of massive risk transfer to the banks.

These risks had to be managed, however, creating a huge market in derivatives for hedging, but risk management was more complex than it seemed, and it was expensive.

Maintaining high returns on investment meant that some risks, deliberately or otherwise, went unhedged.

It all came to an abrupt end in 2008 when the mortgage crisis reached its peak and shattered the industry.

By the end of that year there were no freestanding investment banks left among the leading capital market players – the top five American firms had failed, merged or become banks.

Leading up to the crisis, the big capital market players assumed they were operating in a closed system in which only they, the sophisticated buyers and sellers, existed. In this world of savvy

professionals, caveat emptor applied. Such conduct seemed ruthless and unprincipled to those outside the system when they got a look at it later on.

Of the 20 US firms controlling this business in 1965, all but one – Goldman Sachs – have disappeared as independent firms (Morgan Stanley survived, but it ceased to be independent; it was merged into Dean Witter in 1997).

None of the few surviving independent UK firms were major players. The biggest names had enjoyed more than 40 years of prosperity, capital market development and greatly increased transactions, but had not survived.

Periodic crashes and setbacks occurred, of course, but it was the other stuff that was so hard to adapt to – the deregulation, globalisation, technology and brutally increased competition.

Those with adequate capital and talented people will survive, but only if they adapt. The banks will have to spin off considerable portions of their riskier activities to units outside the heavy capital adequacy umbrella, simplify the risks they retain to be more manageable, apply more discipline to handling conflicts of interest and recruit and pay top producers mainly in company shares.

They will also need to become useful again in providing market solutions to sovereign debt problems in Europe, state and municipal finance in America, and in financing new investments in emerging markets. There are also infrastructure and new energy projects to finance and a backlog of corporate and pension fund restructuring to address. There is plenty to do.

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