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Retirement in the Postcrash World

CORPORATE Finance REVIEW

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THOMSON REUTERS

WHERE DO WE GO FROM HERE? AS THE FINANCIAL CRISIS APPEARS TO EBB, WHAT WILL EMERGE?

As the year 2010 begins, discussions in Washington DC are centered on "reforms"—of the capital markets, commercial banking, financial services, as well as for healthcare and medicine, and additional layers of protection for consumers and investors. How much regulation is "enough" to prevent a repeat of the financial markets crisis of 2007–2009? The number of pages of regulations covering activities in banking and brokerage activities is in the thousands. And these were not enough to prevent the market crisis that began with the freezing of auction rate securities in February 2007.

The stock market crash of 1929 devastated the portfolios of millions of people and the ensuing Great Depression was only broken after a decade by the military buildup and subsequent world war (1941–1945 for the US). In the early 1930s sweeping legislation aimed at the protection depositors and investors was put in place and oversight agencies created to protect banking and securities customers, but that didn't restore trust in the markets or institutions overnight.

However, one key element of these regulations (enacted beginning in 1933 and continuing through 1940) could be the key to twenty-first century consumer protection as well—more on this later.

T'is said that the start of a new century unleashes exciting innovation and invigorates the latent entrepreneurial spirit. Examples offered by the experts include the invention by James Watt of the steam engine, which ushered in the industrial age in England in the turn from the eighteenth to nineteenth century. (Ensuing advances in technology and changes in production processes eventually moved tens of thousands of people off their small agricultural lands and out of cottages and into crowded cities and factories, and gave rise to many of the structures of modern capitalism.)

Other examples include the technological miracles evolving in the late nineteenth century that were widely deployed in the early years of the twentieth: the invention and mass production of self-propelled motor cars; powered flight; the diesel engine; the gasoline internal combustion engine; trans-Atlantic communications; vast, networked telephone networks (the "Bell System"); and the widespread generation of electricity.

So as the twentieth century gave way to the twenty-first, what did the new century bring? Perhaps we will judge it to be the *wrong kind* of innovation, the kind that unleashes destructive forces. The first years of the new century brought a wave of large corporate failures, some caused by major financial and accounting scandals and outright fraud. Consider the case of Enron, which was the seventh-largest listed firm on the *Fortune 500* and which disappeared in the blink of an eye; Arthur Andersen, the Big Five global accounting giant that was Enron's auditor; Global Crossing; Adelphi Communications; and the largest corporate bankruptcy until that time, that of WorldCom (which had operations in almost every US congressional district).

At the end of the first decade of the twenty-first century the casualties of not enough risk management continued to

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mount with the failures of Lehman Brothers and Bear Stearns, two brokerage and investment banking houses in the United States that had both plunged deep into the innovation of, assemblage and global marketing of mortgage-backed securities and other financial exotica. The largest of the US brokerage networks, the venerable Merrill Lynch, teetered on the brink and was saved by Bank of America, which in turn became a troubled institution until the US government stepped in with billions of dollars of direct investment to shore up the holding company's finances.

Numerous other companies skirted along of the edge of the abyss, and suddenly, seeking government help was necessary.

Struggling to survive, General Motors could only live on through transfusions of federal money (which gave the US government a major share of GM ownership). Hundreds of billions of dollars were invested by the US Treasury and Federal Reserve System (the central bankers) in more than 300 banking institutions by the close of the decade. In the depth of the market crisis, such large investment houses as Goldman Sachs requested to become regulated banks! (The good news was that by the end of 2009 a number of the large banking organizations were returning monies to the US Treasury and Federal Reserve.)

The twenty-first century financial innovation led to. . . ?

Much of the market crisis was blamed on the abandonment of effective risk management and the embrace of short-term performance by corporate boards and senior management, especially in the bank holding companies. The all-too distinguishing characteristic of the new century was evidence of poor corporate governance at many companies that led to a mass state of mistrust and a global crisis atmosphere.

What innovation and spirit of entrepreneurship has been demonstrated thus far in the new century? Most of us will not like the answers, especially if we are proponents of the free-market system and the efficient-market theory.

Dramatic advances in technology over the last twenty-five years of the twentieth century yielded powerful data analysis and creative processing tools for Wall Street entrepreneurs and innovators. Often, technological innovations enable and empower advances in such fields as corporate and public finance, banking, investment, and intellectual properties. In this sense, as computing power became less expensive and more widely dispersed, innovation was broadly empowered in both spheres of "financial services"—in traditional (and usually cautious) commercial banking services, and in brokerage and investment banking and related financial services.

The merger frenzy of the earlier years of the twenty-first century—proclaimed as examples of the innovation and entrepreneurship of this new, post–Glass Steagall age—swept through the ranks of both commercial banking and Wall Street companies. *Too small to succeed* at the start of the twenty-first century gave way to the emergence of financial empires that by the end of the first decade were deemed *too big to fail* by government policy makers!

True to the prediction of the experts great change was unleashed at the turn of the new century, and a confluence of major factors reshaped the financial services sector:

- The lines between traditional (depository) banking and its decades of effective risk-management policies and practices and more risk-prone brokerage services were quickly blurred at the highest levels of the new supermarket-style financial services organizations.
- More powerful computing resources allowed for faster and more complex data and market-information processing; more sophisticated trading activities and investment products were evolved, as it turned out many of these were beyond the understanding of senior executives overseeing the enterprise.
- Great faith was placed in untested or theoretical approaches developed by credentialed academics that

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Trust in the new approaches to investing—misplaced?

Professor Paul Krugman—Nobel Laureate, Princeton University economist, and *New York Times* economics commentator—observed in fall 2009, more than a year into the "Great Recession" that clearly marked the end of the first decade of the twenty-first century: "The economics profession went astray because economists, as a group, mistook beauty, clad in impressive-looking mathematics, for truth. Until the Great Depression, most economists clung to a vision of capitalism as a perfect or nearly perfect system. . . . As memories of the Depression faded, economists fell back in love with the old, idealized vision of an economy in which rational individuals interact in perfect markets, this time gussied up with fancy equations."[1]

What happened? Hundreds of academics, especially math professors bearing PhDs marched to Wall Street firms to create elegant, sophisticated structures that (with the help of super-computing systems) created what they thought were fail-safe models for innovating new financial products and services. Many of these models failed in sufficient numbers to create systemic risk. It is almost two years since the collapse of auction rate securities, an early trigger of the market troubles in February 2007, and the credit markets remain closed for many would-be borrowers.

Where do we go from here?

The thousands of pages of rules and regulations that govern commercial banks, industrial banks, diversified financial services firms, insurance companies, mutual funds, and other fiduciary organizations will likely be added to. Public outrage is driving reaction to the financial markets crisis (investors lost $13 trillion in the 2007–2009 period and six million individuals lost their jobs; more than two million have so far lost their homes).

In place of the division of banking and investment services long maintained by the Glass-Steagall Act, we probably will see the creation of a super-regulatory agency, perhaps the proposed Consumer Financial Protection Agency.

There is an ever-widening range of investor and consumer protection legislation being proposed in Congress. Under existing law, the Securities & Exchange Commission is issuing new corporate governance rules. New rules are being considered and/or adopted by the exchanges for their listed companies. Even new state statutes are being passed and rules adopted to protect investors and consumers.

As much as history is being repeated in these actions, the lessons of history will also be important to keep in mind. In the end, financial services innovation and the spirit of entrepreneurship will outstrip the capacities of the public sector to anticipate and oversee the products and services and new approaches that will emerge.

And what may be the most important development may be voluntary. In the sweep of 1930s securities-protection legislation and rule-making the mandarins of that era understood that in addition to the vast network of laws, rules, regulations, and codes for the private sector, what often works best is the self-policing and self-regulation of industry. This was the defining characteristic of the US capitalist system in the twentieth century and may well be the redeeming quality that restores trust to the markets and protects investors and consumers in the twenty-first century as well. ■

NOTES

[1] P. Krugman, "How Did Economists Get It So Wrong?" *New York Times* (September 2, 2009).