

## ECONOMIC NEWS UPDATE

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### **We Still Need an Innovative Financial Sector**

It's not a good idea to stand in front of a stampede and try to talk the cattle into stopping, or to argue with a bunch of lemmings headed for a cliff, that follow-the-leader is not a good idea. Still, we ink-stained wretches of the fourth estate do have responsibilities. So before investors and policy-makers sign onto the idea that bigger is better, that the last two investment banks left standing should find shelter in the arms of big, commercial banks, let me try to make a few contrarian points.

First, and most important, this is not a good time to make decisions about the future structure of the financial services industry. Calm heads have yet to

prevail; the ordinary investor is quite properly seeking shelter from the storm by buying safe government IOUs: and we do not yet know for certain the details of Treasury Secretary Hank Paulson's plan to substitute a general solution for the ad hoc measures he has been taking -- Freddie, Fannie and AIG get saved, Lehman Brothers is allowed to go bust, and Merrill Lynch is forced into the waiting arms of giant Bank of America.

But we do know a few things about what has made America's capital markets work well enough over time to assure that resources are efficiently allocated, that new businesses get funded, and that

badly run or obsolete businesses get starved of capital so that they no longer place a drain on the nation's resources. Not perfectly, and not always, but well enough and often enough to underwrite a high and rising standard of living.

So we should be careful before we wave a fond goodbye to Goldman Sachs and Morgan Stanley, the one fighting to remain independent, the other said to be negotiating with Wachovia to shelter under its not-terribly muscular arms now that China Investment Corp has announced it will not up its current 9.9% stake to 49%.

The question of the survival of these firms is important to more than their shareholders and employees: it is a question of the survival of innovation and entrepreneurship at the heart of the financial system.

Now, I have nothing against large commercial banks. They do a reasonable job of collecting deposits from small customers, aggregating them, and lending the resultant pools of money to businesses, profiting from the difference between what they have to pay depositors and what they can charge commercial borrowers. But when these banks expand into unfamiliar businesses, the management problems become complex, corporatism overtakes individualism, and (at

best) workmanlike management replaces entrepreneurial daring. Or at worst its HBOS.

Which brings me to Goldman Sachs, the poster boy for hard-driving financial capitalism. Its shares have been driven down, and there is a perception that it wouldn't be a bad thing if these masters of the universe got their comeuppance, as did Lehman, which went broke, and Merrill Lynch, which was forced to find a buyer.

That lumps together non-comparable companies. At the time of its takeover by Bank of America, Merrill Lynch had almost six times as much tied up in problem-area loans -- residential and commercial real estate, and leveraged loans to hedge funds -- as it had capital. When Lehman went under, its ratio of shaky loans to its own capital was 3.4 times. Goldman Sachs, on the other hand, saw hard times coming and cut its problem loans from 2 ½ times its own money to a mere one times those funds. Management matters.

In more ways than one. One reason so many of the financial institutions which have disappeared or have gotten into trouble is that they have hesitated to recognize that some of their decisions have been just awful. They have stuff on their books at valuations that are no longer close

to reality, despite the general accounting rule that all assets should be on the books at their current market value -- marking to market is the term accountants use. So instead of taking their medicine in one gulp, they dribble out write-downs every quarter. Goldman, on the other hand, marks its assets to market every day. And more or less gets it right: in the vast majority of its recent sale of mortgage assets, the firm realized prices equal to or in excess of the values it had assigned to these assets.

This is not a pitch for Goldman Sachs. I have no way of knowing whether in the long run it will benefit more from being one of the last banks of its kind, with less competition, than it will be hurt by the slowing of economic activity and deal-making. But I do know that if we end up without these independent sources of ideas and risk-taking, the nation will be the poorer.

I also know that it is more important than ever to preserve independent sources of ideas now that we are likely to have more intrusive government regulation of the financial sector. With some justification. Recent financial innovations created securities so complex that risk managers and rating agencies proved unable to appraise the risks associated with

these complicated securities. Since they and their bank colleagues were quite willing to reap the profits, they should also be made to reap the whirlwind. After all, Hank Paulson has to draw the bail-out line somewhere, and that somewhere is where he drew it in the case of Lehman Brothers -- or thought he did. The theory is clear: in the case of Freddie Mac, Fannie Mae and AIG, the collateral damage of their failure was too gruesome to contemplate. Not so with Lehman Brothers -- right? Surveying the devastation caused by its demise, one has to wonder. Still, it can well be argued that if finance capitalism cannot survive the failure of single investment bank, perhaps capitalism should finally be consigned to the dustbin of history.

Which, fortunately, it will not be. Sensible policy trumps panic every time. Yes, there will be some painful adjustments. And yes, the financial sector will never be quite the same again, with a new mix of public and private sector emphasis. But the dustbin of history will just have to wait for the consignment that will someday follow communism -- and it won't be American capitalism.

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