Commentary

Insiders And Outsiders

Amar Bhide 09.24.08, 5:30 PM ET

The New York Fed has gotten its long-standing wish: Goldman Sachs and Morgan Stanley have become, like Citicorp, bank holding companies subject to its supervision. The increased power may please some Fed officials--and provide a great security blanket for "value" investors like Warren Buffet. But as far as public policy is concerned, this is a step in precisely the wrong direction: We need more focused, transparent financial players, not more "Too Big to Fail" and "Too Complex to Manage" behemoths like Citicorp.

"How could our CEO possibly certify Citicorp's accounts?" complained one of his lieutenants, shortly after Sarbanes-Oxley had been passed. "They are just too complicated." Perhaps, I suggested, Citicorp should be split up into simpler units. Of course not! A flat world needed global financial institutions. If U.S. regulators didn't back off, they'd all flee to London. Outsiders like me just didn't get it.

In fact, the insiders didn't. Stanley O'Neal and James Cayne famously frolicked on golf courses and at bridge tables while Merrill Lynch and Bear Stearns imploded. They weren't callous, just profoundly--and given the complexity of their firms, inevitably--ignorant of the risks. Nor were they the exceptions. The financial system is paralyzed by fear not just of financial institutions hiding bad loans, but also that the insiders who are supposedly in charge don't know the magnitudes of their liabilities.

American industry--businesses in the real economy--long ago learned hard lessons in the virtues of focus. In the 1960s, the prevailing wisdom favored growth through diversification. Many benefits were cited. Besides synergistic cost reductions offered by sharing resources in functions such as manufacturing and marketing, executives of large diversified corporations allegedly could allocate capital more wisely than could external markets. In fact, the synergies often turned out to be illusory, and corporate executives out of touch. Super-allocators like Jack Welch and Warren Buffett were exceptions.

The weaknesses of diversification were sharply exposed by the recession of the early 1980s and by Japanese competition. Later in the decade, raiders used junk bonds to acquire conglomerates at deservedly depressed prices and sold off their components at a handsome profit.

Banks missed the 1960s party. Prohibitions on interstate banking and the separation between investment and commercial banking mandated by the Glass-Steagall Act

severely limited diversification in the financial industry. But as the rules were dismantled in later decades, financial institutions plunged right ahead.

The early results weren't promising. Efforts to sell stocks and socks at Sears went nowhere, as did the Prudential Insurance Company's foray into brokerage and Morgan Stanley's venture into credit cards. But the forces that had curbed diversification in the industrial sector did not restrain financial institutions. Low-cost Japanese competitors did not show up inefficiencies--in many financial businesses, the driver of long-run profits lies in the prudent management of risks and returns, not costs.

Raiders couldn't use junk bonds to dismantle conglomerates; financial institutions are too highly levered to be taken over with borrowed money; compensation arrangements made diversification irresistible. Many financial firms pay out nearly half their gross profits as bonuses--even if these profits are secured by loading up on risk. And bonuses paid are paid forever, even if the bets ultimately go bad.

Diversification offered CEOs the opportunity to take ever larger bets--and earn staggering personal returns without much personal risk. CEO Richard Fuld's Lehman stock may now be worthless--but he gets to keep the $500 million he took out in previous years. James Cayne may have fallen off the Forbes 400 list, but he isn't in the poor house. Sandy Weil has laughed all the way away from Citibank, which he turned into a hodgepodge of investment banking, trading, retail brokerage, commercial banking and insurance.

Even now, battered CEOs seem bent on doubling up to recoup their bad diversification bets instead of cleaning house. Last year, Bank of America CEO Ken Lewis declared that he had had "all the fun I can stand in investment banking." Yet last week, Lewis engineered the acquisition of Merrill Lynch. Now Goldman and Morgan Stanley, in their new holding company incarnation, are looking to acquire deposit-rich regional banks.

Predictably, taxpayers are footing much of the bill for the misadventures in diversification. Regulators, who looked the other way while bankers put the public's deposits at risk and brought the nation's economy to its knees, now have an opportunity to redeem themselves. They ought to demand an unraveling of the tangle that would help separate the good from the bad, and create institutions whose books CEOs could honestly certify.

Instead, they are encouraging more diversification, hoping to bury, for instance, Merrill Lynch's unknown liabilities into Bank of America's impenetrable balance sheets, and--in spite of their past failures with the likes of Citicorp--welcoming the creation of more megabanks. This is rather like giving the addict in the ER more drugs. It may soothe the tremors, but it isn't a long-term solution to the diversification debacle.

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