PERSONALLY SPEAKING

Special Issue April 20, 2010

FIXING WALL STREET BEGINS WITH DUMPING TOXIC SENIOR MANAGERS

Edward J. O'Boyle, Ph.D.
Mayo Research Institute

Recent allegations by the Securities and Exchange Commission that Goldman Sachs defrauded investors by selling a product tied to the performance of certain mortgages without disclosing that a hedge fund which helped design the product was shorting those mortgages compels us to revisit a question which arose forcefully in September 2008. What can we do to rein in this kind of abuse, what should we do?

The full details of the SEC case at this time have not been disclosed, and Goldman Sachs has not yet presented its defense. Thus, it is unwise to speculate as to exactly what transpired and to prejudge the outcome of the case.

We would be inclined to allow the Goldman Sachs case to run its course through the current regulatory/legal process were it not tied to the systemic financial crisis which exploded in September 2008 and quickly locked up financial markets in the United States and, by shutting down vital sources of credit, threatened to spread to product and resource markets and in turn to the entire global economy. Many commentators considered it the worst crisis since the Great Depression.

The 2008 financial meltdown was a long time in the making, having originated with defaults in sub-prime, adjustable-rate mortgages and spreading to giant U.S. investment banks and financial institutions elsewhere which had purchased huge bundles of mortgage-backed securities on the promise of a return on their investment which would boost their bottom line. The crisis was further exacerbated by the development of credit default swaps that were intended to provide investors with insurance for any losses from borrowers unable to meet their obligations.

Federal government intervention came swiftly though clumsily as it searched for the right remedies. It settled on bailing out financial institutions thought to be too big to fail. A vocal minority urged the government to let the markets deal with the problem by eliminating failed institutions. Their pleas were swept aside.

What we have learned over the last year and a half is that there are only three basic options available to address this "mess." First, we can eliminate moral hazard -- encouraging riskier behavior by assuring risk-takers that they will be bailed out when their schemes fail -- by abolishing "too big to fail," but then we run the risk of systemic failure. Second, we can reduce the risk of systemic failure by creating a safety net, increasing the regulatory power, or both, but then we run into moral hazard. Third, we can abolish "too big to fail" and moral hazard by relying on competent and trustworthy management to protect against the risk of system failure, but then we have not eliminated risk entirely.

The first option appeals to libertarians who reject all government intervention in economic affairs. The second option is attractive to progressives who embrace more aggressive government intervention. The third appeals to moderates who support a limited role for government in certain aspects of economic affairs.

The first option falls short because the huge performance bonuses paid by Wall Street institutions represent an open invitation to swindlers and scammers who prey on investors who have not done their due diligence before committing their funds. If and when the swindlers and scammers are identified and brought to justice, the investors they duped may not be able to recoup their losses. Though the Bernie Madoff ponzi scheme is the worst example of this kind of criminal abuse, the handsome financial rewards for pulling it off guarantee that it will not be the last.

Even Alan Greenspan who for years served as chairman of the Federal Reserve Board of Governors admits that the premise that the unfettered market system sorts out all of such problems is seriously flawed. In testifying before Congress in October 2008, Greenspan's admitted that "Those of us who looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief."

The second option is based on the premise that government regulators are well positioned to uncover the swindlers and scammers and are able to make them pay for their ill-gotten gains. There are two specific weak points to that premise. First, the staffs at the regulatory agencies too often are short-handed, inexperienced, and overwhelmed by the workload. In a report just released by the SEC's own inspector general, the Commission is charged with taking eight years (1997 to 2005) to follow up on evidence that Allen Stanford was operating a ponzi scheme that fleeced investors of approximately $8 billion. Second, swindlers and scammers come and go and with the new entrants new schemes to deceive and defraud investors. The crooks, in other words, are a step ahead of the cops.

Mayo Research Institute strongly favors the third option, even though it does not resolve the problem entirely. The reason is that this option puts the policing function in the hands of the senior managers of Wall Street financial institutions who are best positioned to know what is happening in the nooks and crannies of financial markets. In this regard, they must be held to a higher standard than "credible deniability."

If senior bank executives had rejected those mortgage-backed securities when they were offered and their boards of directors had insisted on following that course of action, mortgages would not have been made available to persons/families who could not afford to make their monthly payments, housing prices would not have been inflated, the defaults which followed would not have taken place, the housing bubble would not have developed, and the credit freeze would not have happened because banks would have continued to trust one another knowing that due diligence and moderation protected them against collapse. The 2008 meltdown was set in motion by human beings and will take humans to put the proper remedies in place.

It's plain to anyone even remotely familiar with the operations of Wall Street institutions that we need to replace some of the senior managers and directors or change the way they operate. In the end, the reason U.S. taxpayers acting through the Federal Reserve System got saddled with more than one trillion dollars of toxic mortgage-backed securities taken

off the books of Wall Street's huge investment banks is that those banks freely ingested those securities on the promise of very substantial returns. When those securities surfaced as toxic in September 2008, some analysts wrongly identified them as the problem. Those securities are symptomatic of a much deeper problem – bank officials so absorbed with maximizing net personal advantage that they did not understand or give a second thought to the heightened systemic risk originating in their day-to-day operations. Those managers – we refer to them as toxic managers – were and remain the problem.

If we decide to replace the senior managers and directors, will we be able to find trustworthy and competent replacements to assume the management and direction of those problem-banking institutions? Would those replacements not be drawn from the very same institutional culture, which boosted performance by reckless decision-making rewarded and reinforced by huge bonuses? What would keep the expelled senior executives from simply finding work at other banks?

If these people indeed cannot be replaced, how do we change the institutional culture so that sound judgment and steadfastness are restored and recklessness and greed are driven out? This is the age-old question, which has puzzled humankind since the ancient Greek philosophers. At this very moment, we face a terribly troubling dilemma: leave the senior managers and directors in place and risk a repeat performance or replace them and risk poor performance.

There are two factors working in our favor: fear and role modeling. Some senior executives and their junior-level colleagues can be frightened into changing their behavior by severely punishing the ones who have most egregiously violated the public trust. Today that would be the persons like Bernie Madoff who amassed enormous ill-gotten wealth through various schemes of deception and fraud. They must be publicly disgraced, stripped of their holdings to the full extent possible so that their victims can "claw back" their investments to the full extent possible. And they should be prosecuted with no plea-bargaining and no "country-club" imprisonment. Upon release they should be banned for life from owning, working in, or serving as a director of a financial institution. Likewise for those elected officials sitting on Congressional oversight committees and public regulators who have either pushed the financial institutions under their supervision into risky behavior or turned a blind eye to clear abuses.

Other bank executives can change their behavior by the role-modeling of superiors and mentors who are recruited from the pool of retired military officers whose lives have been shaped and formed by the six articles of the military code of conduct and by duty, honor, and country. Other high-level replacements can be drawn from the senior managers of regional banks and community banks who have steered their institutions away from the false promises offered by bundles of high-risk assets.

Reforming and reconstructing our financial institutions in a one-time effort that seeks to assure that the latest crisis will not happen again is doomed to failure. **Recall a similar mess in the 1980s with U.S. savings and loans that in a reckless pursuit of higher returns from risky investments collapsed under the weight of bad loans. It follows that reform efforts must be ongoing in order to change a dangerous and ultimately dysfunctional institutional culture. To extend Thomas Jefferson well-known admonition, "eternal vigilance is the price of freedom, fairness, and security in financial affairs."**

There is nothing fundamentally wrong with being paid handsomely for work done well and nothing intrinsically right about imposing a ceiling on the compensation of senior executives. The financial gains from work done well are the stuff, which makes possible sharing and caring for others. There are more than one million public charities and private foundations in the United States which in the end not only rely on contributions from persons who have earned their financial rewards but also provide opportunities for their donors to transform financial gain into human virtue. And virtue, to the ancient Greeks, is the secret of the good life. Unless the practice of virtue, notably in the form of the practical virtues of justice, prudence, fortitude, and moderation, somehow is infused into the system there is no way to get rid of a toxic culture poisoning the ranks of senior financial executives.

Systemic failure is human failure on a massive scale in which senior managers whether knowingly or heedlessly put at risk their own organizations in the pursuit of bloated returns and net personal advantage. Fixing Wall Street begins with dumping these toxic senior managers.

Edward J. O'Boyle is Senior Research Associate with Mayo Research Institute.
Offices in New Orleans, Lake Charles, and West Monroe
www.mayoresearch.org 318-381-4002 edoboyle@earthlink.net