European Research Studies,
Volume XV, Issue (3), 2012

Government Regulations Come Always after Big Crises. Are Bankers Next to Split Following the Auditors?

Theodore Pelagidis[1], Yanni Moutafidis[2]

Abstract:

When things are good nobody asks why. When things are too good to be true, only a few realise that it is true. When things finally turn bad everybody finds out that the emperor has no clothes on. Then, promising politicians take over the crisis to save the world. Is this process just human nature where the system works always in favour of the ruling class, or well-educated humans is a must for a true democracy? In any case, society would be better-off when informed, rather than ignorant.

In this short note, we offer an explanation for the current persisting mediocre growth rate mainly in the US. At the centre of our analysis and explanation for the above matter lie the persisting structural distortions found in the US banking industry.. We focus on the investment banking system in particular as we are considering it as the absolutely principal factor that circulates and allocates capital in the globe. We show why and how this system malfunctions, we focus on the conflicts of interest and we finally offer both an explanation and a way out of the current Wall Street institutional distortions, which we consider of critical importance for bringing back the US as well as the western economy as a whole, back on track.

In addition, our view also offers an indirect explanation about the inability of the Western economies to succeed high growth rates, reducing government debt and unemployment at the same time. It is in fact the inability to substantially reform the banking system, leaving it substantially operating as before, that drags down the economy to inadequate growth rates, despite repetitive programs of Quantitative Easing (QE) by the FED in the US or "backdoor QE" in Europe.

Key Words: *Financial markets, Government policy and financial regulation*

JEL Classification*: G18, G15, G28*

[1] **Corresponding author:** *Professor, University of Piraeus, 21 Lambraki, Piraeus 185 33, Greece. Tel./Fax: +30-210-4142526. Email: pelagidi@unipi.gr. Senior Fellow, The Brookings Institution, US*

[2] *Olympic Asset Management, financier and chairman. 1 King's Court North, 189 King's Road, Chelsea, London SW3 5EQ, UK, T(+44)2073515865, M(+44)7733117522*
Email: YanniM@OlympianFunds.com

المنارة للاستشارات
www.mar

1. Crisis Part I: Auditors Split from "Creative Accounting" Consultants by Sarbanes-Oxley Act in the US

During the formation of the dotcom bubble in the 90's, when everybody was profiting, the Auditors couldn't be left behind. So, being "creative", they came up with the idea to offer accounting consultancy to clients they were promptly due to audit afterwards, tripling their revenues in the process. Consequently, everybody was looking successful. The auditors had more revenues, the corporations were showing more profits, the Investment Banks and other professionals in the financial industry had more business, and investors' portfolios were inflating along with the stock market bubble. All in all, the "paper economy" seemed to be performing well and the politicians' leadership looked very effective.

During the bear market 2000-2002, when everybody found out that the emperor has no clothes on, the bubble deflated and the domino effect worked again in the real economy. Corporate scandals in "blue chip" companies like Enron and WorldCom could not be hidden or "cooked" any longer. Then, while previously successful looking professionals began blaming each-other for all the painful consequences affecting the lives and fortunes of many people, promising government officials intervened again to punish the criminals and save the unprotected public from the "crooks". Market regulations were once again the prescribed medication. As a result of this mini crisis, the oldest jewel of the Auditing Industry, (Arthur Andersen), became the martyr, as it was essentially forced into liquidation in 2002. Shortly afterwards, the rest of the industry sold-off their consultancy business, in compliance to one of the key directives of the "Sarbanes-Oxley Act" that separates the conflicting business of *Consulting* from that of *Auditing*.

2. Why Regulators Act Always After a Big Crisis but Never Before?

Were the above conflicting services offered from the Auditors until recently the only ones offered in the financial marketplace? Are there any other major conflicting services offered today by the main participants in the financial markets? What about the services offered by the Banks in the Buying and Selling process of financial products with respect to the public interest? Are there perhaps obvious conflicting interests between departments within Banks waiting to be painfully discovered again by the public, and to be followed once again by regulatory interventions after the next big crisis in the global financial system? Is there really any so called "Chinese Wall" between the departments of an organisation, or is it just a public attraction, like the "Wall" in modern China today which is part of the interrelated World Trade Organisation? And if these concerns are valid, why are legislators again waiting for the crisis to appear first, before taking any action?

المنارة للاستشارات
www.mar

As history teaches and helps us to predict the future, a reasonable person should wonder why elected government officials act always after a crisis but never before. A person well educated in history has only to recall and attempt to justify the timing of the following major regulatory interventions in the financial industry (coincidentally always after disasters) during the last century: Why was a new oversight body, the Securities and Exchange Commission, created in 1934 following the biggest crash to date in the Dow Jones index (-90%) from its peak in 1929, accompanied with the largest number of rules and regulations governing all financial markets in the USA? (Bernanke 2004, Ahamed 2009). Why was the Banking industry separated by the Glass-Steagall act into Commercial Banking (accepts deposits) and Investment Banking (underwrites securities) in 1933, in order to reduce conflicts of interests and restore confidence in the banking system following the crash in the Dow Jones (-90%) and the USA depression in the 30s?

Why was the daily computerised program trading in the NYSE regulated just after the one day mini crash in the Dow Jones (-22%) on the 19th of October 1987? Why was the auditing industry forced by the "Sarbanes-Oxley Act" of 2002 to spin off its "creative accounting" consultancy services after the discovery of corporate scandals in the USA, causing serious damages to employees, investors and to the broader public in general? Why did the Chairman of the US Congress' Banking Committee, Senator Paul Sarbanes, ironically, introduced the "Sarbanes-Oxley Act" in 2002 to regulate public corporate governance and audited reporting, after the burst of the dotcom bubble of the 90's that revealed the corporate scandals of Enron and WorldCom and not before, when in a family gathering in the mid 90's he told me that the financial markets where "adequately regulated"? Why was he not aware of the dual and conflicting services of auditing and the same time "creative accounting" consulting offered to the same clients from the Auditing companies during the 90s? Why did the Attorney General and candidate Governor of New York at that time Eliot Spitzer punish most Wall Street brokerage firms by imposing fines for illegal practices in 2003 after the burst of the dotcom bubble of the 90s, when competing to get investment banking business broke down the "Chinese Wall" that was created after the 1929 stock market crash to separate Investment Banking from Research and Asset Management? (Kaiser 2009).

Well, the most popular government official to investors, and the biggest enemy as well as friend of the financial services companies today in the USA was at that time, the former Attorney General and ex-Governor of New York, Eliot Spitzer. His decision to run for Governor of New York State was an example that probably helps us to answer all of the above questions. Maybe, he had the need to become popular to voters/investors that lost money following the burst of the dotcom bubble, by becoming an apparent enemy to the financial services companies he punished But, in fact also their friend, considering that he just scratched the surface of the conflicting interests issue regarding the services offered by them today. Otherwise, someone should naturally wonder why no previous Attorney Generals or other elected officials didn't fulfil the job for which they had been elected before any

المنارة للاستشارات
www.mar

crises, or why previous government oversight bodies were not sufficiently well informed to act pre-emptively during the formation of the crises, by introducing the Glass-Steagall or the Sarbanes-Oxley Acts earlier?

We don't know why. We don't know why regulators act always after a big crisis but never before. One thing we all know is that the financial industry was the biggest campaign financing contributor to both parties in the USA, especially before the abolition of the Glass-Steagall Act, ironically, at the peak of the dotcom bubble in 1999.

In the market economy of a "Democracy with equal opportunities", the public/voters expect from governments to structure an efficient and competitive market place in order to allow the "invisible hand" to function effectively and fairly for all participants. Thus, either the legislators didn't foresee the above mentioned crises during their formation, and as such were not competent enough, or they did see them coming but chose to look the other way for reasons which I can only suspect. What is certain in business, however, is that any expense in the corporate world has to be justified to the shareholders. Therefore, any corporate contribution to campaign financing has to be reimbursed in some form, some day, from the recipient.

3. Today, "Chinese Wall" Attracts Rather Than Splits the Public to Sell and Buy Side

Today, there is an obvious question arising from the government legislation of the Sarbanes-Oxley Act; why didn't regulators stick the knife all the way down to the bone of the financial industry, to also eliminate the conflicting interests between services offered by the Banks to the public? Either they didn't notice any conflicting practices in the trading process on the part of the banks, or they are aware of them but have a reason to wait for the next big crisis before acting again. More specifically, why the US Congress, led by the banking committee headed by Senator Paul Sarbanes, didn't examine the overall transparency, competitiveness and fairness in the market place in order to reinforce it by their act? Did they really examine the selling and buying process and the participants' role in the evaluation and trading of these "blue chip" companies like Enron and WorldCom at those exuberant prices just before their bankruptcy? In the same line of thought, why did former Attorney General Spitzer limited the investigation behind the "Chinese Wall" to the Analysts level, and did not proceed all the way down to the Asset Management level (buy side), which we assume should also be separated by this famous "Wall" due to the conflicting interest it has with the Investment Banking division (sell side)? Is it not obvious that the Asset Management division (buy side) is in direct conflict with the Investment Banking division (sell side) of a Bank, both services being offered to the public from the Banks today?

المنارة للاستشارات
www.man

Finally, should we wait, after the big financial crisis of 2008, for a double-dip to come and crash like a bomb in the hands of President Obama before future political candidates/legislators intervene to bring into equilibrium the sophistication and competitiveness existing only in the SELL side today, into the BUY side as well, allowing the markets to function efficiently through a competitive price system by reaching fair prices and being immune to periodic "irrational exuberances"? (Rajan 2011).

As we know, the more sophisticated and competitive the demand and supply sides are in any marketplace, the fairer the prices will be. This is not an advanced economic theory candidate for a Nobel Prize. This is simply elementary level textbook theory of "supply and demand", taught in first year economics. Why are economists/regulators unable to see this and resolve it today? Why can't they identify the sophistication and the means available to the supply side that tries to sell at the highest possible price and profits mainly when markets go up (Bull Markets), vis-à-vis the demand side that should try to buy at the lowest possible price and also profit when markets go up, but which suffers the risk too when markets go down (Bear Markets)? The supply or sell side of the financial market, composed of Banks (Investment and Commercial today), Mutual Fund companies, stock exchanges, financial media (newspapers, magazines, TV, radio, etc), indexing companies, rating companies, research and data providers to the market, and many other professions profiting from rising markets, are all pitched against the demand or buy side. However, the buy side is largely composed of the majority of unsophisticated investors specialised in their own line of business but not in investing, the "professional money managers" that "belong" to the supply side institutions anyway and whose sole motivation is the generation of fees on sales transactions and assets under management, the Pension Funds that do not dare to deviate from their benchmarks, and only recently selected real Hedge Funds; a very small but rapidly growing group of extremely sophisticated professionals, investing alongside with their investors/clients and motivated by the profits generated from the capital under management. Unfortunately, trading prices and the overall valuation of the markets are determined by the participants from the demand side and their willingness to buy a financial asset at a specific price. If the sophisticated supply side can convince part of the demand side that Enron, Amazon.com or Microsoft, for example are undervalued trading at 100 times their P/E ratio (perhaps calculated by the recently discovered "creative accounting" techniques), the transaction will take place whether the market is at a bubble level or not. The average unsophisticated investor who bought either from the broker who makes a living selling stocks, or via a Mutual/Pension Fund whose manager is obliged to be invested at all times following the mandatory benchmark, or through a tailored-made portfolio managed by a private banker who is no better than the mutual fund managers of the same Bank, or via an index fund whose computer/manager simply follows the index, is the majority of the demand side and will passively find out in the future whether the market was over or under valued. Only investors who invest via selected real Hedge Funds,

المنارة للاستشارات
www.mar

alongside proven successful hedge fund managers, can be objectively considered to be part of the minuscule (less than 3% today) sophisticated demand side that would probably sell short (i.e., a bet that the price will fall) the above mentioned shares, should they have realised that the market or the specific shares were overvalued. We should all keep in mind that it was Hedge Fund short-sellers who first identified financial juggling at Enron and other companies, and who cried "wolf" to US regulators.

4. Whatever Shines Is Not a Hedge Fund

Over the last twenty to thirty years this growing but still tiny portion of the demand side, which used to be called "smart money", has been successfully investing only through hedge funds. This indisputable investment success is clearly shown in black and white audited profit numbers, and not in well designed marketing brochures, TV commercials, "unbiased" articles in popular financial newspapers or other promotional means employed by the "traditional" asset management services, offered by all sell side financial institutions today. Of particular importance is the continued success of this unbiased investment approach during the bear market years from 2000 to 2002. Understandingly, the result has been the recent geometric growth of assets under management in hedge funds worldwide, from US$ 400 billion in 2000 to US$ 2 trillion today. This is the reason why Banks and other sales oriented financial institutions have again recently adapted to their clients' investment maturity levels, by including some packages of hedge funds in their range of investment products available for sale to them. In the course of time, we can observe that the offered investment products by the Banks have improved profitability for the clients/investors along with their improved maturity in investing. From the un-audited discretionary accounts or brokerage advice in the 70s and '80s, the investment products offered by the Banks have improved to the audited but with negative Alpha (less than the markets' Beta) returns of the traditional Mutual Funds, followed by the Index Funds in the 90s which generate small profit margins left for the Banks and, finally, to Alternative Investment products in the 2000s. However, the results of such Alternative Investment packages offered by the Banks today in relation to the authentic hedge funds industry's performance by category have been very mediocre so far due to the alternative managers' selection process by inexperienced Bankers/Brokers in performance oriented investment vehicles. In addition, this selection process includes again conflicts of interest arising from the kickbacks or "soft dollars" generated via trading commissions offered by average managers to the transaction fees oriented nature of the Bankers/Brokers, coupled with a growing number of "Speculative Funds" misleadingly attaching to themselves the fashionable label, "Hedge Fund". In other words, whatever shines in the Alternative Investment packages offered by the Banks or other vendors today are not necessarily Hedge

المنارة للاستشارات
www.man

Funds. The notorious bankruptcies from the "Long-Term Capital Management" in 1998 headed by shiny Nobel Prize winners in economics to the "Amaranth Advisors" recently, clearly demonstrates examples of speculative funds calling themselves "Hedge Funds" in order to capitalise on their long term proven success for marketing purposes. As we all know, the main investors of these speculative and overleveraged funds were clients of financial institutions such as Morgan Stanley, Goldman Sachs, Credit Swiss, MAN Group and other.

Consequently, day by day an increasing number of investors realise that the poor performance of their portfolios is due to the existing conflicts of interests between the asset management division (which should buy optimally for them) and the investment banking division (which should sell indiscriminately to any buyer, including them, any financial product), both housed within the same organization or with its subsidiaries. Well, we argue that the more investors realise these conflicts in relation to their interests and wake-up by shifting their capital to asset management companies belonging to the buy side only, the quicker will the demand side make its sophisticated presence felt in the market place, and hence the sooner will markets trade efficiently at fairer valuations. But how long will it take for this shift of investors capital from sell side to buy side investment companies to bring about equilibrium in the markets, and how many more bubbles and bursts are investors likely to suffer in the process? (Fleckenstein(2008)

We strongly believe that either the investors will continue to learn by experiencing poor performances and the financial industry will continue adapting the offered products to their learning curve, or government regulations following a second, "double dip" big crisis in the financial system worldwide will eventually bring about the desired equilibrium and, therefore, competitiveness in the marketplace. Whichever comes first or a combination of both. Unfortunately, our predictions are not so optimistic for the broader public which we think will continue to suffer again and again, as always in history. The politicians/legislators need to take advantage of the current big crisis in order to act by law for the separation of the "one-stop financial shop" banks, servicing clients from the buy as well as the sell side of the market today, into two independent professions with competing services and interests within the financial industry (Lewis 2010, 2011). On the one hand the sell side institutions composed of the investment banks acting as advisers, underwriters, etc. for their corporate clients, and on the other hand the buy side professional entities made up of the Asset Management Companies acting on behalf of the investors. Unfortunately for the public again, as always, the conservative politicians' argument is: "If not broke try not to fix it". But, why does "preventative medicine" have a proven value in the health industry but not in the financial industry? And after all, why have legislators separated the pharmacists from the medical doctors in the health industry?

المنارة للاستشارات
www.mar

5. Big Banks Abandon the "One-Stop Financial Shop" and Split from Asset Management

There are already signs of radical "business" and legal restructuring, silently and smoothly taking place, among the largest leading multinational Banks which have lately adopted the "one-stop financial shop" strategy to service all their clients. Giant banks have quietly given up their recently adopted "financial supermarket" strategy by selling off, exchanging or legally disassociating their Asset Management business from their core banking and broker-dealer entities operations, especially after the burst of the bubble in 2008. But even by the end of 2005 and during 2006, CitiGroup had exchanged its Asset Management business with Legg Mason's broker-dealer business and acquired a significant equity interest in the company, UBS had sold its private banks & GAM unit to its 21% subsidiary of the enlarged Julius Bear and Merrill Lynch had "sold" its Asset Management unit (which includes its mutual funds family) to BlackRock, its 50% subsidiary today.

But what happened suddenly to the Bankers' highly expensive campaign financing contributions to both parties in the USA, fighting for the abolition of the Glass-Steagall Act since its inception in 1933 that finally came in 1999, allowing them at last to apply their main "financial supermarket" strategy in the Banking industry? Is the recent business separation of the asset managers from the broker-dealers (the Buyers from the Sellers) in the Banking industry just as a coincidence following the "Sarbanes-Oxley Act" and the imposed fines to most Wall Street brokerage firms for illegal practices in 2003 after the burst of the dotcom bubble of the 90s, or were these "amicable business divorces" more of a prudent and quiet "off the record" suggestion from the legislators/regulators to their big campaign financing contributors in order to prepare them for the coming regulatory separation?

Such precautionary action from the big players in Banking, clearly demonstrates the sense of inevitability they feel with regard to a regulatory or market-forced separation of the buy from the sell side in the financial industry, sooner rather than later. These leading multinational Banks have, perhaps, taken their lesson from the recent regulatory intervention which separated the conflicting services offered by the Auditing Industry. No big Bank can afford to be the Arthur Andersen martyr of the Banking Industry without any opportunity to legally defend its professional practices. Maybe, this is the reason why we are observing the start of a trend in the Banking Industry to separate, purely from a legal stand point so far, the buying from the selling services entities, before regulators force them to do so in a hurried and disadvantageous for them manner. The Bankers are smart enough to prepare a smooth, but in reality, only a legal "spin-off" of their buying or selling activity, before they are obliged to do so by law collectively after the next big financial crisis, in a similar fashion to what the Auditing Industry had to go through (Acharya and Richardson (2009)).

المنارة للاستشارات
www.man

So, should legislators wait for the next big financial failure, similar to the case of 2008 "Lehman Crisis" or of Long Term Capital which may not be as wisely handled by the presiding government officials at the time, or should they act pre-emptively today by eliminating inefficiencies in financial markets before a crisis explodes? (Rogoff and Reinhart 2009). It is a matter of time when the globally interrelated banking system will experience an important failure followed by a big crisis which could, for example, come from the mishandling of a large and miscalculated major trade in derivatives which are also considered as "a time bomb" in the financial system from successful professional investors like Warren Buffet. It is reminded that it is the derivative market that has substantially paralysed the Eurozone's banking system and has mainly provoked the severe turbulences that the EU member-states are currently experiencing.

And finally, should the broad public continue to manage its financial affairs in the same way it purchases consumer goods, influenced by the marketing and selling techniques used by the sellers side of the financial industry today, or is it time for the investors to be assisted by powerful and independent professional entities from the buyers side, acting on their interests and being remunerated only by them? Is it also time for the broader public to become better informed and educated in handling its financial matters in today's demanding lifestyle, by including a basic finance course in our elementary education similar to mathematics or composition, as the current Fed Chairman Ben Bernanke has also suggested?

We believe that the sooner governments act to establish the power of a sophisticated, competitive and efficient framework in the marketplace by law, which will separate and reinforce the competing interests between the BUY and SELL side, the better it will be for our society which otherwise risks to realise again and again that the emperor has no clothes on.

References

1. Acharya, V. and M. Richardson (2009), *Restoring Financial Stability*, NY, Wiley
2. Ahamed, L. (2009), *Lords of Finance*, NY, The Penguin Press.
3. Bernanke, B. (2004), *The Great Depression*, New Jersey, Princeton.
4. Fleckenstein, W. (2008), *Greenspan Bubbles*, NY, McGraw Hill.
5. Kaiser, G. (2009), *So Damn Much Money*, NY, Knopf.
6. Lewis, M. (2010), *The Big Short*, London, Allen Lane.
7. Lewis, M. (2011), *Boomerang,* London, Allen Lane.
8. Rajan, R. (2011), *Fault Lines*, New Jersey, Princeton.
9. Rogoff, K and C. Reinhart, *This Time is Different*, New Jersey, Princeton.

المنارة للاستشارات

www.mar

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

للاستشارات المنارة

www.manaraa.com