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Letters

Investment bankers have behaved like pyromaniac firemen

From Prof Eric De Keuleneer.

Sir, Your editorial "Bankers are fallible but not replaceable" (January 3) is right to stress the role of Wall Street in the subprime debacle but you may be too optimistic about the effect of regulation on the behaviour of investment banks.

The leveraged buy-out hype in the 1980s and the dotcom bubble in the 1990s showed the tendency of Wall Street bankers to depart from the ethical behaviour on which many of them had once put great emphasis.

When they were shown to have defrauded their clients, the fines were much lower than the fraudulent profits. The feeble measures imposed (not by regulators, but by Elliot Spitzer, the then attorney-general of New York), namely the reinforcement of deficient Chinese walls, fell short of the outright separation of broking and investment banking many people felt necessary.

Regulators still do not intervene much, even though abuses abound in the investment banking world. Allotments of underpriced initial

public offerings and soft commissions allow for routine corruption. Aggressive marketing of dubious financial instruments becomes even more suspicious when banks take massive short positions in instruments they sell to clients as being "admittedly very complex but offering great value".

Investment banks also aggressively promote mergers and acquisitions by telling companies that if they make no acquisitions they risk being downgraded by analysts (for "having no strategy") and acquired themselves.

Yet the high "success" fee they charge does not usually translate into success for the acquirers – since many studies show that more than 60 per cent of acquisitions seem to fail – or for the market economy – since many acquisitions aim at enhancing pricing power by reducing competition, which is hardly good for a market economy.

You are, of course, right to say that Wall Street and the City of London make a number of bankers very wealthy, which spills into other parts

of the economy. But the same can be said of any system of wealth concentration.

The main question is whether this wealth corresponds to value creation or value diversion. The answer to this would shed more light on the question of the real use of Wall Street.

We know by now that ethics do not pay, or not enough, in finance and that investment bankers (like some other professions) make much more money when their creativity is unhindered by ethical consideration.

Should they therefore be more heavily regulated? Some claim this could also limit their creativity, but what would we lose if that was the case?

They claim to have vastly increased the liquidity of financial markets, but we know now this is a fair-weather illusion. They also claim they created instruments that reduced and helped to control risk, but we now know risk was only displaced or hidden.

Like pyromaniac firemen, investment bankers may also be

increasing volatility and risk through their support of speculative behaviour in the first place.

They claim they made markets more efficient, yet during the past 30 years financial markets have misallocated huge funds to finance over-consumption by the leisured classes in developing countries, along with hollow internet projects and more recently dubious real estate deals. Hardly a stellar performance in efficiency of fund allocation.

In a nutshell, the improvement in the quality of financial services may not be enough to justify the trebling of the proportion of financial sector revenues in US gross domestic product over the past 30 years, but may instead be the result of the failure – so far – of regulation to compensate for a dramatic lowering of ethical standards in the financial sector.

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