The Economist Looks at American Finance

If there is any consensus about American finance, it is that it is a mess. Five years on from the financial crisis, billions of dollars have been spent on litigation and settlements, and hundreds of thousands of pages of new legislation have been added to America's already vast library of securities laws. Yet justice has not been achieved, and the system's integrity has not been secured. If a private financial market truly exists in America, why has it not done what markets are meant to do? How has it failed to enforce the standards of conduct needed to reassure customers?

That is the vexing question at the heart of "The Death of Corporate Reputation" by Jonathan Macey, a professor at Yale Law School. It was not always thus, he reminds readers. Citing just one example from a recent (if bygone) era, in 1994 Bankers Trust, one of America's largest financial institutions, sold toxic swaps to two clients. The legal consequences paled before the market reaction. Customers fled; independence was lost.

Contrast this, Mr Macey observes, to the experience of Goldman Sachs, which profited from the financial crisis by selling clients investments in its "Abacus" fund, a portfolio of mortgages designed to fail. Or consider Morgan Stanley, which provided critical information about Facebook during the social-media company's initial public offering to select customers only. Then there are the major ratings agencies and accountancies whose opinions on the banks' financial health turned out to be so very wrong. Each of these institutions continues to play an important role in America's financial markets.

This flies in the face of the long-held view that financial intermediaries are meant to fill the gap in trust between the entities that seek and those that provide capital. This assumes that investment banks, accountancy firms, law firms and rating agencies in effect "rent" their reputations to issuers, giving confidence to the market. It is therefore in the interest of these companies to develop reputations for honesty and trustworthiness. Those with strong reputations are then less likely to engage in damaging practices, because they have so much to lose. In short, firms will be good if the system rewards them for it. Why is this no longer the case?

Mr Macey provides three answers. The first is that clients increasingly value individuals who work within investment banks or accountancy firms more than they do the firms themselves. Select employees remain valuable even when the firms they work for implode, as was the case with certain partners at Arthur Andersen, an audit firm that went bust in 2002.

Second, for the most sophisticated edge of finance, firms are now often less important to clients than the customised products they merely assemble for buyers seeking results, such as the ability to hedge a particular risk. Firms used

to use their reputation to become architects of deals; now they are just assemblers, and that has changed their culture.

Last, and perhaps most important, a vast profusion of laws, regulations and direct government interventions has provided a substitute for reputation, albeit a toxic and inadequate one. This was long obvious in the case of deposit insurance, which ensures that Americans can now afford to be indifferent about the solvency of the institutions that hold their money. But it is increasingly true in other areas of finance as well. Requirements for ratings and audits, for instance, are now set by regulation, not the market, and an entire new federal agency, the Consumer Financial Protection Agency, has been created to expand this approach in retail finance.

As a result, Mr Macey writes, there is little need for financial intermediaries to invest in their reputations. It is, however, important for them to invest in regulators, whose own career prospects are increasingly tied to their ability to advance rules that are both vague and highly technical, as this increases their value both within government and to potential private employers. The system is now fundamentally flawed, concludes Mr Macey. Those who propose even more regulations will only ensure more damage. There was a time when such an argument would have been seen as academic. Not any more. A vital market is emerging for plausible ideas.