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WHAT GOOD IS WALL STREET?

Much of what investment bankers do is socially worthless.

by John Cassidy

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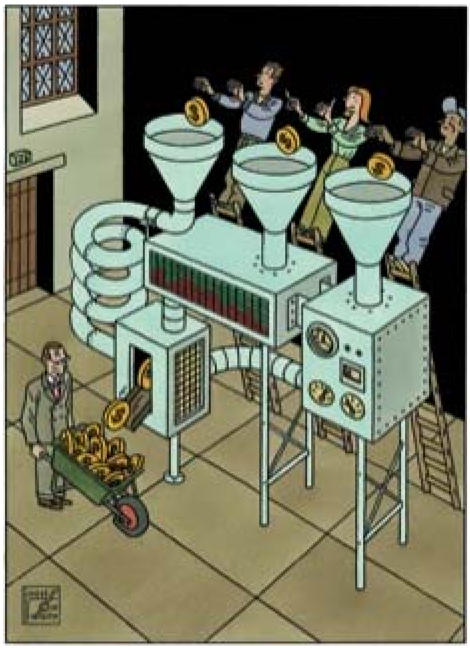

For years, the most profitable industry in America has been one that doesn't design, build, or sell a single tangible thing.

A few months ago, I came across an announcement that Citigroup, the parent company of Citibank, was to be honored, along with its chief executive, Vikram Pandit, for "Advancing the Field of Asset Building in America." This seemed akin to, say, saluting BP for services to the environment or praising Facebook for its commitment to privacy. During the past decade, Citi has become synonymous with financial misjudgment, reckless lending, and gargantuan losses: what might be termed asset denuding rather than asset building. In late 2008, the sprawling firm might well have collapsed but for a government bailout. Even today the U.S. taxpayer is Citigroup's largest shareholder.

The award ceremony took place on September 23rd in Washington, D.C., where the Corporation for Enterprise Development, a not-for-profit organization dedicated to expanding economic opportunities for low-income families and communities, was holding its biennial conference. A ballroom at the Marriott Wardman Park was full of government officials, lawyers, tax experts, and community workers, two of whom were busy at my table lamenting the impact of budget cuts on financial-education programs in Vermont.

Pandit, a slight, bespectacled fifty-three-year-old native of Nagpur, in western India, was seated near the front of the room. Fred Goldberg, a former commissioner of the Internal Revenue Service who is now a partner at Skadden, Arps, introduced him to the crowd, pointing out that, over the years, Citi has taken many initiatives designed to encourage entrepreneurship and thrift in impoverished areas, setting up lending programs for mom-and-pop stores, for instance, and establishing savings accounts for the children of low-income families. "When the history is written, Citi will be singled out as one of the pioneers of the asset movement," Goldberg said. "They have demonstrated the capacity, the vision, and the will."

Pandit, who moved to the United States at sixteen, is rarely described as a communitarian. A former investment banker and hedge-fund manager, he sold his investment firm to Citigroup in 2007 for eight hundred million dollars, earning about a hundred and sixty-five million dollars for himself. Eight months later, after Citi announced billions of dollars in writeoffs, Pandit became the company's new C.E.O. He oversaw the company's near collapse in 2008 and its moderate recovery since.

Clearly, this wasn't the occasion for Pandit to dwell on his career, or on the role that Citi's irresponsible actions played in bringing on the subprime-mortgage crisis. (In early 2007, his predecessor, Charles Prince, was widely condemned for commenting, "As long as the music is playing, you've got to get up and dance.") Instead, Pandit talked about how well-functioning banks are essential to any modern society, adding, "As President Obama has said, ultimately there is no dividing line between Wall Street and Main Street. We will rise or we will fall together as one nation." In the past couple of years, he went on, Citi had rededicated itself to "responsible finance." Before he and his colleagues approved any transaction, they now asked themselves three questions: Is it in the best interests of the customer? Is it systemically responsible? And does it create economic value? Pandit indicated that other financial firms were doing the same thing. "Banks have learned how to be banks again," he said.

About an hour later, I spoke with Pandit in a sparsely furnished hotel room. Citi's leaders—from Walter Wriston, in the nineteen-seventies, to John Reed, in the nineteen-eighties, and Sanford Weill, in the late nineteen-nineties—have tended to be formidable and forbidding. Pandit affects a down-to-earth demeanor. He offered me a cup of coffee and insisted that I sit on a comfortable upholstered chair while he perched on a cheap plastic one. I asked him if he saw any irony in Citi being commended for asset building. His eyes widened slightly. "Well," he said, "the award we are receiving is for fifteen years of work. It was work that was pioneered by Citi to get more financial inclusion. And it's part of a broader reform effort we are involved in under the heading of responsible banking."

Since Pandit took over, this effort has involved selling or closing down some of Citi's riskier trading businesses, including the hedge fund that he used to run; splitting off the company's most foul-smelling assets into a separate entity, Citi Holdings; and cutting the pay of some senior executives. For 2009 and 2010, Pandit took an annual salary of one dollar and no bonus. (He didn't, however, give back any of the money from the sale of his hedge fund.) "This is an apprenticeship industry," he said to me. "People learn from the people above them, and they copy the actions of the people above them. If you start from the top by acting responsibly, people will see and learn."

Barely two years after Wall Street's recklessness brought the global economy to the brink of collapse, the sight of a senior Wall Street figure talking about responsible finance may well strike you as suspicious. But on one point Pandit cannot be challenged. Since the promulgation of Hammurabi's Code, in ancient Babylon, no advanced society has survived without banks and bankers. Banks enable people to borrow money, and, today, by operating electronic-transfer systems, they allow commerce to take place without notes and coins changing hands. They also play a critical role in channelling savings into productive investments. When a depositor places money in a savings account or a C.D., the bank lends it out to corporations, small businesses, and families. These days, Bank of America, Citi, JPMorgan Chase, and others also help corporations and municipalities raise money by issuing stocks, bonds, and other securities on their behalf. The business of issuing securities used to be the exclusive preserve of Wall Street firms, such as Morgan Stanley and Goldman Sachs, but during the past twenty years many of the dividing lines between ordinary banks and investment banks have vanished.

When the banking system behaves the way it is supposed to—as Pandit says Citi is now behaving—it is akin to a power utility, distributing money (power) to where it is needed and keeping an account of how it is used. Just like power utilities, the big banks have a commanding position in the market, which they can use for the benefit of their customers and the economy at large. But when banks seek to exploit their position and make a quick killing, they can cause enormous damage. It's not clear now whether the bankers have really given up their reckless practices, as Pandit claims they have, or whether they are merely lying low. In the past few years, all the surviving big banks have raised more capital and become profitable again. However, the U.S. government was indirectly responsible for much of this turnaround. And in the country at large, where many businesses rely on the banks to fund their day-to-day operations, the power still isn't flowing properly. Over-all bank lending to firms and households remains below the level it reached in 2008.

The other important role of the banking industry, historically, has been to finance the growth of vital industries, including railroads, pharmaceuticals, automobiles, and entertainment. "Go back and pick any period in time," John Mack, the chairman of Morgan Stanley, said to me recently. "Let's go back to the tech boom. I guess it got on its feet in the late eighties, with Apple Computer and Microsoft, and really started to blossom in the nineteen-nineties, with Cisco, Netscape, Amazon.com, and others. These are companies that created a lot of jobs, a lot of intellectual capital, and Wall Street helped finance that. The first investors were angel investors, then venture capitalists, and to really grow and build they needed Wall Street."

Mack, who is sixty-six years old, is a plainspoken native of North Carolina. He attended Duke on a football scholarship, and he retains the lean build of an athlete. We were sitting at a conference table in his large, airy office above Times Square, which features floor-to-ceiling windows with views of the Hudson. "Today, it's not just technology—it's clean tech," he went on. "All of these industries need capital—whether it is ethanol, solar, or other alternative-fuel sources. We can give you a list of companies we've done, but it's not just Morgan Stanley. Wall Street has been the source of capital formation."

There is something in what Mack says. Morgan Stanley has raised money for Tesla Motors, a producer of electric cars, and it has invested in Bloom Energy, an innovator in fuel-cell technology. Morgan Stanley's principal rivals, Goldman Sachs and JPMorgan, are also canvassing investors for ethanol producers, wind farms, and other alternative-energy firms. Banks, of course, raise money for less environmentally friendly corporations, too, such as Ford, General Electric, and ExxonMobil, which need cash to fund their operations. It was evidently this business of raising capital (and creating employment) that Lloyd Blankfein, Goldman's chief executive, was referring to last year, when he told an interviewer from a British newspaper that he and his colleagues were "doing God's work."

Yet Wall Street's role in financing new businesses is a small portion of what it does. The market for initial public offerings (I.P.O.s) of stock by U.S. companies never fully recovered from the tech bust. During the third quarter of 2010, just thirty-three U.S. companies went public, and they raised a paltry five billion dollars. Most people on Wall Street aren't finding the next Apple or promoting a green rival to Exxon. They are buying and selling securities that are tied to existing firms and capital projects, or to something less concrete, such as the price of a stock or the level of an exchange rate. During the past two decades, trading volumes have risen exponentially across many markets: stocks, bonds, currencies, commodities, and all manner of derivative securities. In the first nine months of this year, sales and trading accounted for thirty-six per cent of Morgan Stanley's revenues and a much higher proportion of profits. Traditional investment banking—the business of raising money for companies and advising them on deals—contributed less than fifteen per cent of the firm's revenue. Goldman Sachs is even more reliant on trading. Between July and September of this year, trading accounted for sixty-three per cent of its revenue, and corporate finance just thirteen per cent.

In effect, many of the big banks have turned themselves from businesses whose profits rose and fell with the capital-raising needs of their clients into immense trading houses whose fortunes depend on their ability to exploit day-to-day movements in the markets. Because trading has become so central to their business, the big banks are forever trying to invent new financial products that they can sell but that their competitors, at least for the moment, cannot. Some recent innovations, such as tradable pollution rights and catastrophe bonds, have provided a public benefit. But it's easy to point to other innovations that serve little purpose or that blew up and caused a lot of collateral damage, such as auction-rate securities and collateralized debt obligations. Testifying earlier this year before the Financial Crisis Inquiry Commission, Ben Bernanke, the chairman of the Federal Reserve, said that financial innovation "isn't always a good thing," adding that some innovations amplify risk and others are used primarily "to take unfair advantage rather than create a more efficient market."

Other regulators have gone further. Lord Adair Turner, the chairman of Britain's top financial watchdog, the Financial Services Authority, has described much of what happens on Wall Street and in other financial centers as "socially useless activity"—a comment that suggests it could be eliminated without doing any damage to the economy. In a recent article titled "What Do Banks Do?," which appeared in a collection of essays devoted to the future of finance, Turner pointed out that although certain financial activities were genuinely valuable, others generated revenues and profits without delivering anything of real worth—payments that economists refer to as rents. "It is possible for financial activity to extract rents from the real economy rather than to deliver economic value," Turner wrote. "Financial innovation . . . may in some ways and under some circumstances foster economic value creation, but that needs to be illustrated at the level of specific effects: it cannot be asserted a priori."

Turner's viewpoint caused consternation in the City of London, the world's largest financial market. A clear implication of his argument is that many people in the City and on Wall Street are the financial equivalent of slumlords or toll collectors in pin-striped suits. If they retired to their beach houses en masse, the rest of the economy would be fine, or perhaps even healthier.

Since 1980, according to the Bureau of Labor Statistics, the number of people employed in finance, broadly defined, has shot up from roughly five million to more than seven and a half million. During the same period, the profitability of the financial sector has increased greatly relative to other industries. Think of all the profits produced by businesses operating in the U.S. as a cake. Twenty-five years ago, the slice taken by financial firms was about a seventh of the whole. Last year, it was more than a quarter. (In 2006, at the peak of the boom, it was about a third.) In other words, during a period in which American companies have created iPhones, Home Depot, and Lipitor, the best place to work has been in an industry that doesn't design, build, or sell a single tangible thing.

From the end of the Second World War until 1980 or thereabouts, people working in finance earned about the same, on average and taking account of their qualifications, as people in other industries. By 2006, wages in the financial sector were about sixty per cent higher than wages elsewhere. And in the richest segment of the financial industry—on Wall Street, that is—compensation has gone up even more dramatically. Last year, while many people were facing pay freezes or worse, the average pay of employees at Goldman Sachs, Morgan Stanley, and JPMorgan Chase's investment bank jumped twenty-seven per cent, to more than three hundred and forty thousand dollars. This figure includes modestly paid workers at reception desks and in mail rooms, and it thus understates what senior bankers earn. At Goldman, it has been reported, nearly a thousand employees received bonuses of at least a million dollars in 2009.

Not surprisingly, Wall Street has become the preferred destination for the bright young people who used to want to start up their own companies, work for NASA, or join the Peace Corps. At Harvard this spring, about a third of the seniors with secure jobs were heading to work in finance. Ben Friedman, a professor of economics at Harvard, recently wrote an article lamenting "the direction of such a large fraction of our most-skilled, best-educated, and most highly motivated young citizens to the financial sector."

Most people on Wall Street, not surprisingly, believe that they earn their keep, but at least one influential financier vehemently disagrees: Paul Woolley, a seventy-one-year-old Englishman who has set up an institute at the London School of Economics called the Woolley Centre for the Study of Capital Market Dysfunctionality. "Why on earth should finance be the biggest and most highly paid industry when it's just a utility, like sewage or gas?" Woolley said to me when I met with him in London. "It is like a cancer that is growing to infinite size, until it takes over the entire body."

From 1987 to 2006, Woolley, who has a doctorate in economics, ran the London affiliate of GMO, a Boston-based investment firm. Before that, he was an executive director at Barings, the venerable British investment bank that collapsed in 1995 after a rogue-trader scandal, and at the International Monetary Fund. Tall, soft-spoken, and courtly, Woolley moves easily between the City of London, academia, and policymaking circles. With a taste for Savile Row suits and a keen interest in antiquarian books, he doesn't come across as an insurrectionary. But, sitting in an office at L.S.E., he cheerfully told me that he regarded himself as one. "What we are doing is revolutionary," he said with a smile. "Nobody has done anything like it before."

At GMO, Woolley ran several funds that invested in stocks and bonds from many countries. He also helped to set up one of the first "quant" funds, which rely on mathematical algorithms to find profitable investments. From his perch in Angel Court, in the heart of the City, he watched the rapid expansion all around him. Established international players, such as Citi, Goldman, and UBS, were getting bigger; new entrants, especially hedge funds and buyout (private equity) firms, were proliferating. Woolley's firm did well, too, but a basic economic question niggled at him: Was the financial industry doing what it was supposed to be doing? Was it allocating capital to its most productive uses?

At first, like most economists, he believed that trading drove market prices to levels justified by economic fundamentals. If an energy company struck oil, or an entertainment firm created a new movie franchise, investors would pour money into its stock, but the price would remain tethered to reality. The dotcom bubble of the late nineteen-nineties changed his opinion. GMO is a "value investor" that seeks out stocks on the basis of earnings and cash flows. When the Nasdaq took off, Woolley and his colleagues couldn't justify buying high-priced Internet stocks, and their funds lagged behind rivals that shifted more of their money into tech. Between June, 1998, and March, 2000, Woolley recalled, the clients of GMO—pension funds and charitable endowments, mostly—withdrew forty per cent of their money. During the ensuing five years, the bubble burst, value stocks fared a lot better than tech stocks, and the clients who had left missed more than a sixty-per-cent gain relative to the market as a whole. After going through that experience, Woolley had an epiphany: financial institutions that react to market incentives in a competitive setting often end up making a mess of things. "I realized we were acting rationally and optimally," he said. "The clients were acting rationally and optimally. And the outcome was a complete Horlicks." Financial markets, far from being efficient, as most economists and policymakers at the time believed, were grossly inefficient. "And once you recognize that markets are inefficient a lot of things change."

One is the role of financial intermediaries, such as banks. Rather than seeking the most productive outlet for the money that depositors and investors entrust to them, they may follow trends and surf bubbles. These activities shift capital into projects that have little or no long-term value, such as speculative real-estate developments in the swamps of Florida. Rather than acting in their customers' best interests, financial institutions may peddle opaque investment products, like collateralized debt obligations. Privy to superior information, banks can charge hefty fees and drive up their own profits at the expense of clients who are induced to take on risks they don't fully understand—a form of rent seeking. "Mispricing gives incorrect signals for resource allocation, and, at worst, causes stock market booms and busts," Woolley wrote in a recent paper. "Rent capture causes the misallocation of labor and capital, transfers substantial wealth to bankers and financiers, and, at worst, induces systemic failure. Both impose social costs on their own, but in combination they create a perfect storm of wealth destruction."

Woolley originally endowed his institute on dysfunctionality with four million pounds. (By British standards, that is a significant sum.) The institute opened in 2007—Mervyn King, the governor of the Bank of England, turned up at its launch party—and has published more than a dozen research papers challenging the benefits that financial markets and financial institutions bring to the economy. Dmitri Vayanos, a professor of finance at L.S.E. who runs the Woolley Centre, has presented some of its research at Stanford, Columbia, the University of Chicago, and other leading universities. Woolley has published a ten-point "manifesto" aimed at the mutual funds, pension funds, and charitable endowments that, through payments of fees and commissions, ultimately help finance the salaries of many people on Wall Street and in the City of

London. Among Woolley's suggestions: investment funds should limit the turnover in their portfolios, refuse to pay performance fees, and avoid putting money into hedge funds and private-equity firms.

Before leaving for lunch at his club, the Reform, Woolley pointed me to a recent study by the research firm Ibbotson Associates, which shows that during the past decade investors in hedge funds, over all, would have done just as well putting their money straight into the S&P 500. "The amount of rent capture has been huge," Woolley said. "Investment banking, prime broking, mergers and acquisitions, hedge funds, private equity, commodity investment—the whole scale of activity is far too large." I asked Woolley how big he thought the financial sector should be. "About a half or a third of its current size," he replied.

When I got back from London, I spoke with Ralph Schlosstein, the C.E.O. of Evercore, a smallish investment bank of about six hundred employees that advises corporations on mergers and acquisitions but doesn't do much in the way of issuing and trading securities. In the nineteen-seventies, Schlosstein worked on Capitol Hill as an economist before joining the Carter Administration, in which he served at the Treasury and the White House. In the eighties, he moved to Wall Street and worked for Lehman with Roger Altman, the chairman and founder of Evercore. Eventually, Schlosstein left to co-found the investment firm Blackrock, where he made a fortune. After retiring from Blackrock, in 2007, he could have moved to his house on Martha's Vineyard, but he likes Wall Street and believes in it. "There will always be a need for funding from businesses and households," he said. "We saw at the end of 2008 and in early 2009 what happens to an economy when that capital-raising and capital-allocation mechanism breaks down. Part of what has distinguished the U.S. economy from the rest of the world is that we've always had large, transparent pools of capital. Ultimately, that drives down the cost of capital in the U.S. relative to our competitors."

Still Schlosstein agrees with Woolley that Wall Street has problems, many of which derive from its size. In the early nineteen-eighties, Goldman and Morgan Stanley were roughly the size of Evercore today. Now they are many, many times as large. Big doesn't necessarily mean bad, but when the Wall Street firms grew beyond a certain point they faced a set of new challenges. In a private partnership, the people who run the firm, rather than outside shareholders, bear the brunt of losses—a structure that discourages reckless risk-taking. In addition, small banks don't employ very much capital, which allows them to make a decent return by acting in the interests of their clients and relying on commissions. Big firms, however, have to take on more risk in order to generate the sorts of profits that their stockholders have come to expect. This inevitably involves building up their trading operations. "The leadership of these firms tends to go towards people who can deploy their vast amounts of capital and earn a decent return on it," Schlosstein said. "That tends to be people from the trading and capital-markets side."

Some kinds of trading serve a useful economic function. One is market-making, in which banks accumulate large inventories of securities in order to facilitate buying and selling on the part of their clients. Banks also engage in active trading to meet their clients' wishes either to lay off risk or to take it on. American Airlines might pay Morgan Stanley a fee to guarantee that the price of its jet fuel won't rise above a certain level for three years. The bank would then make a series of trades in the oil-futures markets designed to cover what it would have to pay American if the price of fuel rose. However, the mere fact that a certain trade is client-driven doesn't mean it is socially useful. Banks often design complicated trading strategies that help a customer, such as a pension fund or a wealthy individual, circumvent regulatory requirements or reduce tax liabilities. From the client's viewpoint, these types of financial products can create value, but from society's perspective they merely shift money around. "The usual economists' argument for financial innovation is that it adds to the size of the pie," Gerald Epstein, an economist at the University of Massachusetts, said. "But these types of things don't add to the pie. They redistribute it—often from taxpayers to banks and other financial institutions."

Meanwhile, big banks also utilize many kinds of trading that aren't in the service of their traditional clients. One is proprietary trading, in which they bet their own capital on movements in the markets. There's no social defense for this practice, except the argument that the banks exist to make profits for the shareholders. The so-called Volcker Rule, an element of this year's Dodd-Frank financial-reform bill intended to prevent banks from taking too many risks with their depositors' money, was supposed to have proscribed banks from proprietary trading. However, it is not yet clear how the rule will be applied or how it will prevent some types of proprietary trading that are difficult to distinguish from market-making. If a firm wants to place a bet on falling interest rates, for example, it can simply have its market-making unit build up its inventory of bonds.

The Dodd-Frank bill also didn't eliminate what Schlosstein describes as "a whole bunch of activities that fell into the category of speculation rather than effectively functioning capital markets." Leading up to the collapse, the banks became heavily involved in facilitating speculation by other traders, particularly hedge funds, which buy and sell at a frenetic pace, generating big fees and commissions for Wall Street firms. Schlosstein picked out the growth of credit-default swaps, a type of derivative often used purely for speculative purposes. When an investor or financial institution buys this kind of swap, it doesn't purchase a bond itself; it just places a bet on whether the bond will default. At the height of the boom, for every dollar banks issued in bonds, they might issue twenty dollars in swaps. "If they did a hundred-million-dollar bond issue, two billion dollars of swaps would be created and traded," Schlosstein said. "That's insane." From the banks' perspective, creating this huge market in side bets was very profitable insanity. By late 2007, the notional value of outstanding credit-default swaps was about sixty trillion dollars—more than four times the size of the U.S. gross domestic product. Each time a financial institution issued a swap, it charged the customer a commission. But wagers on credit-default swaps are zero-sum games. For every winner, there is a loser. In the aggregate, little or no economic value is created.

Since the market collapsed, far fewer credit-default swaps have been issued. But the insidious culture that allowed Wall Street firms to peddle securities of dubious value to pension funds and charitable endowments remains largely in place. "Traditionally, the relationship between Wall Street and its big clients has been based on the 'big boy' concept," Schlosstein explained. "You are dealing with sophisticated investors who can do their own due diligence. For example, if CALPERS"—the California Public Employees Retirement System—"wants to buy something that a major bank is selling short, it's not the bank's responsibility to tell them. On Wall Street, this was the accepted way of doing business." Earlier this year, the Securities and Exchange Commission appeared to challenge the big-boy concept, suing Goldman Sachs for failing to disclose material information about some subprime-mortgage securities that it sold, but the case was resolved without Goldman's admitting any wrongdoing. "This issue started to get discussed, then fell to the wayside when Goldman settled their case," Schlosstein said.

The big banks insist that they have to be big in order to provide the services that their corporate clients demand. "We are in one hundred and fifty-nine countries," Vikram Pandit told me. "Companies need us because they are going global, too. They have cash-management needs all around the world. They have capital-market needs all around the world. We can meet those needs." More than two-thirds of Citi's two hundred and sixty thousand employees work outside the United States. In the first nine months of this year, nearly three-quarters of the firm's profits emanated from Europe, Asia, and Latin America. In Brazil, Citi helped Petrobras, the state-run oil company, to issue stock to the public; in the United Kingdom, it helped raise money for a leveraged buyout of Tomkins, an engineering company.

"It's all about clients," Pandit went on. The biggest mistake Citi and other banks made during the boom, he said, was coming to believe that investing and trading on their own account, rather than on behalf of their clients, was a basic aspect of banking. Even before the Dodd-Frank bill was passed, Pandit was closing down some of Citi's proprietary businesses and trying to sell others. "Proprietary trading is not the core of what banking is about," he said. In place of a business model that was largely dependent on making quick gains, he is trying to revive a banking culture based on cultivating long-term relationships with Citi's customers. "Once you make your business all about relationships, conflicts of interest are not an issue," he said.

Despite Pandit's efforts to remake Citi's culture, the firm remains heavily involved in trading of various kinds. Its investment-banking arm, which has grown rapidly over the past decade, still accounts for about three-tenths of its revenues (close to twenty billion dollars in the first nine months of this year) and more than two-thirds of its net profits (upward of six billion dollars in the same period). And within the investment bank about eighty cents of every dollar in revenues came from buying and selling securities, while just fourteen cents of every dollar came from raising capital for companies and advising them on deals. Between January and September, Citigroup's bond traders alone generated more than twelve and a half billion dollars in revenues—more than the bank's entire branch network in North America.

Many banks believe that trading is too lucrative a business to stop, and they are trying to persuade government officials to enforce the Dodd-Frank bill in the loosest possible way. Morgan Stanley and other big firms are also starting to rebuild their securitization business, which pools together auto loans, credit-card receivables, and other forms of credit, and then issues bonds backed by them. There have even been some securitizations of prime-mortgage loans. I asked John Mack if he could see subprime-mortgage bonds making a comeback. "I think in time they will," he replied. "I hope they do. I say that because it gives tremendous liquidity to the markets."

"Liquidity" refers to how easy or difficult it is to buy and sell. A share of stock in a company on the Nasdaq is a very liquid asset: using a discount brokerage such as Fidelity, you can sell it in seconds for less than ten dollars. A chocolate factory is an illiquid asset: disposing of it is time-consuming and costly. The classic justification for market-making and other types of trading is that they endow the market with liquidity, and throughout the financial industry I heard the same argument over and over. "You can't not have banks, and you can't not have trading," an executive at a big private-equity firm said to me. "Part of the value in a stock is the knowledge that you can sell it this afternoon. Banks provide liquidity."

But liquidity, or at least the perception of it, has a downside. The liquidity of Internet stocks persuaded investors to buy them in the belief they would be able to sell out in time. The liquidity of subprime-mortgage securities was at the heart of the credit crisis. Home lenders, thinking they would always be able to sell the loans they made to Wall Street firms for bundling together into mortgage bonds, extended credit to just about anybody. But liquidity is quick to disappear when you need it most. Everybody tries to sell at the same time, and the market seizes up. The problem with modern finance "isn't just about excessive rents and a misallocation of capital," Paul Woolley said. "It is also crashes and bad macroeconomic outcomes. The recent crisis cost about ten per cent of G.D.P. It made tackling climate change look cheap."

In the upper reaches of Wall Street, talk of another financial crisis is dismissed as alarmism. Last fall, John Mack, to his credit, was one of the first Wall Street C.E.O.s to say publicly that his industry needed stricter regulation. Now that Morgan Stanley and Goldman Sachs, the last two remaining big independent Wall Street firms, have converted to bank holding companies, a legal switch that placed them under the regulatory authority of the Federal Reserve, Mack insists that proper supervision is in place. Fed regulators "have more expertise, and they challenge us," Mack told me. Since the middle of 2007, Morgan Stanley has raised about twenty billion dollars in new capital and cut in half its leverage ratio—the total value of its assets divided by its capital. In addition, it now holds much more of its assets in forms that can be readily converted to cash. Other firms, including Goldman Sachs, have taken similar measures. "It's a much safer system now," Mack insisted. "There's no question."

That's true. But the history of Wall Street is a series of booms and busts. After each blowup, the firms that survive temporarily shy away from risky ventures and cut back on leverage. Over time, the markets recover their losses, memories fade, spirits revive, and the action starts up again, until, eventually, it goes too far. The mere fact that Wall Street poses less of an immediate threat to the rest of us doesn't mean it has permanently mended its ways.

Perhaps the most shocking thing about recent events was not how rapidly the big Wall Street firms got into trouble but how quickly they returned to profitability and lavished big rewards on themselves. Last year, Goldman Sachs paid more than sixteen billion dollars in compensation, and Morgan Stanley paid out more than fourteen billion dollars. Neither came up with any spectacular new investments or produced anything of tangible value, which leads to the question: When it comes to pay, is there something unique about the financial industry?

Thomas Philippon, an economist at N.Y.U.'s Stern School of Business, thinks there is. After studying the large pay differential between financial-sector employees and people in other industries with similar levels of education and experience, he and a colleague, Ariell Reshef of the University of Virginia, concluded that some of it could be explained by growing demand for financial services from technology companies and baby boomers. But Philippon and Reshef determined that up to half of the pay premium was due to something much simpler: people in the financial sector are overpaid. "In most industries, when people are paid too much their firms go bankrupt, and they are no longer paid too much," he told me. "The exception is when people are paid too much and their firms don't go broke. That is the finance industry."

On Wall Street dealing desks, profits and losses are evaluated every afternoon when trading ends, and the firms' positions are "marked to market"—valued on the basis of the closing prices. A trader can borrow money and place a leveraged bet on a certain market. As long as the market goes up, he will appear to be making a steady profit. But if the market eventually turns against him his capital may be wiped out. "You can create a trading strategy that overnight makes lots of money, and it can take months or years to find out whether it is real money or luck or excessive risk-taking," Philippon explained. "Sometimes, even then it is hard." Since traders (and their managers) get evaluated on a quarterly basis, they can be paid handsomely for placing bets that ultimately bankrupt their companies. "In most industries, a good idea is rewarded because the company generates profits and real cash flows," Philippon said. "In finance, it is often just a trading gain. The closer you get to financial markets the easier it is to book funny profits."

During the credit boom of 2005 to 2007, profits and pay reached unprecedented highs. It is now evident that the bankers were being rewarded largely for taking on unacknowledged risks: after the subprime market collapsed, bank shareholders and taxpayers were left to pick up the losses. From an economy-wide perspective, this experience suggests that at least some of the profits that Wall Street bankers claim to generate, and that they use to justify their big pay packages, are illusory. Such a subversive notion has recently received the endorsement of senior figures at the Bank of England. Andrew Haldane, the executive director of financial stability at the Bank, gave a speech in July titled "The Contribution of the Financial Sector: Miracle or Mirage?" It concluded, "Because banks are in the risk business, it should be no surprise that the run-up to the crisis was hallmarked by imaginative ways of manufacturing this commodity, with a view to boosting returns to labour and capital. . . . It is in bank managers' interest to make mirages look like miracles."

Under pressure from the regulators, the big Wall Street banks have responded to criticisms over executive compensation with something called "clawback." Rather than paying hefty bonuses in cash every January or February, a bank gives its most highly paid employees some sort of deferred compensation designed to decline in value if "profits" turn into losses. The simplest way of doing this is to issue bonuses in the form of restricted stock that can't be sold for a long period of time. If the firm gets into trouble as a result of decisions taken years earlier, and its stock price declines, those responsible will suffer. Morgan Stanley pays bonuses in cash, but places the cash in a restricted account where it can't be used for a certain number of years. If during this period the investment that generated the bonus turns into a loss, the firm has the right to take back some or all of the cash.

The spread of clawback provisions shows that there has been some change on Wall Street. But it's unclear if the schemes will hold up when inevitably challenged in court—or if they'll deter traders from taking unwarranted risks. On

Wall Street and elsewhere in corporate America, insiders generally learn quickly how to game new systems and turn them to their advantage. A key question about clawbacks is how long they remain in effect. At Morgan Stanley the answer is three years, which may not be long enough for hidden risks to materialize. "It's just very easy to create trading strategies that make money for six years and lose money in the seventh," Philippon said. "That's exactly what Lehman did for six years before its collapse."

Given the code of silence that Wall Street firms impose on their employees, it is difficult to get mid-level bankers to speak openly about what they do. There is, however, a blog, The Epicurean Dealmaker, written by an anonymous investment banker who has for several years been providing caustic commentary on his profession. The biography on his site notes, "I facilitate, justify, and advise parties to M&A transactions, when I am not advising against them." In March, 2008, when some analysts were suggesting that the demise of Bear Stearns would lead to a change of attitudes on Wall Street, TED—the shorthand appellation the author uses—wrote, "I, for one, think these bankers will be even more motivated to rape and pillage the financial system in order to rebuild their ill-gotten gains." Seven months later, on the eve of the bank bailout, TED opined, "Let hundreds of banks fail. Let tens of thousands of financial workers lose their jobs and their personal wealth. . . . The financial sector has had a really, really good run for a lot of years. It is time to pay the piper, and I, for one, have little interest in using my taxpayer dollars to cushion the blow. After all, I am just another heartless Wall Street bastard myself."

In September, TED and I met at a diner near my office. He looked like an investment banker: middle-aged, clean-cut, wearing an expensive-looking gray suit. Our conversation started out with some banter about the rivalry between bankers and traders at many Wall Street firms. As the traders came out on top in recent years, TED recalled, "they would say, 'You guys are the real parasites, going to expensive lunches and doing deals on the back of our trading operations.' " He professed to be unaffected by this ribbing, but he said, "In my experience, the proprietary traders are always the clowns who make twenty million dollars a year until they lose a hundred million."

In September, 2009, addressing the popular anger about bankers' pay, TED wrote that he wouldn't "attempt to rationalize stratospheric pay in the industry on the basis of some sort of self-aggrandizing claim to the particular socioeconomic utility or virtue of what I and my peers do," and he cautioned his colleagues against making any such claim: "You mean to tell me your work as a [fill in the blank here] is worth more to society than a firefighter? An elementary school teacher? A combat infantryman in Afghanistan? A priest? Good luck with that." The fact was, TED went on, "my pay is set according to one thing and one thing only: the demand in the marketplace for my services. . . . Investment bankers get paid a lot of money because that is what the market will bear."

While not inaccurate, this explanation raises questions about how competition works in the financial industry. If Hertz sees much of its rental fleet lying idle, it will cut its prices to better compete with Avis and Enterprise. Chances are that Avis and Enterprise will respond in kind, and the result will be lower profits all around. On Wall Street, the price of various services has been fixed for decades. If Morgan Stanley issues stock in a new company, it charges the company a commission of around seven per cent. If Evercore or JPMorgan advises a corporation on making an acquisition, the standard fee is about two per cent of the purchase price. I asked TED why there is so little price competition. He concluded it was something of a mystery. "It's a commodity business," he said. "I can do what Goldman Sachs does. You can do what I can do. Nobody has a proprietary edge. And if you do have a proprietary edge you'll only have it for a few weeks before somebody reverse engineers it."

After thinking it over, the best explanation TED could come up with was based on a theory of relativity: investment-banking fees are small compared with the size of the over-all transaction. "You are a client, and you are going to do a five-billion-dollar deal," he said. "It's the biggest deal you've ever done. It's going to determine your future, and the future of your firm. Are you really going to fight about whether a certain fee is 2.5 per cent or 3.3 per cent? No. The old cliché we rely on is this: When you need surgery, do you go to the discount surgeon or to the one you trust and know, who charges more?"

I asked him how he and his co-workers felt about making loads of money when much of the country was struggling. "A lot of people don't care about it or think about it," he replied. "They say, it's a market, it's still open, and I'll sell my labor for as much as I can until nobody wants to buy it." But you, I asked, what do you think? "I tend to think we do create value," he said. "It's not a productive value in a very visible sense, like finding a cure for cancer. We're middlemen. We bring together two sides of a deal. That's not a very elevated thing, but I can't think of any elevated economy that doesn't need middlemen."

The Epicurean Dealmaker is right: Wall Street bankers create some economic value. But do they create enough of it to justify the rewards they reap? In the first nine months of 2010, the big six banks cleared more than thirty-five billion dollars in profits. "The cataclysmic events took place in the fall of 2008 and the early months of 2009," Roger Altman, the chairman of Evercore, said to me. "In this industry, that's a long time ago."

Despite all the criticism that President Obama has received lately from Wall Street, the Administration has largely left the great money-making machine intact. A couple of years ago, firms such as Citigroup, JPMorgan Chase, and Goldman Sachs faced the danger that the government would break them up, drive them out of some of their most lucrative business lines—such as dealing in derivatives—or force them to maintain so much capital that their profits would be greatly diminished. "None of these things materialized," Altman noted. "Reforms and changes came in, but they did not have a transformative effect."

In 1940, a former Wall Street trader named Fred Schwed, Jr., wrote a charming little book titled "Where Are the Customers' Yachts?," in which he noted that many members of the public believed that Wall Street was inhabited primarily by "crooks and scoundrels, and very clever ones at that; that they sell for millions what they know is worthless; in short, that they are villains." It was an extreme view, but public antagonism toward bankers and other financiers kept them in check for forty years. Economic historians refer to a period of "financial repression," during which regulators and policymakers, reflecting public suspicion of Wall Street, restrained the growth of the banking sector. They placed limits on interest rates, prohibited deposit-taking institutions from issuing securities, and, by preventing financial institutions from merging with one another, kept most of them relatively small. During this period, major financial crises were conspicuously absent, while capital investment, productivity, and wages grew at rates that lifted tens of millions of working Americans into the middle class.

Since the early nineteen-eighties, by contrast, financial blowups have proliferated and living standards have stagnated. Is this coincidence? For a long time, economists and policymakers have accepted the financial industry's appraisal of its own worth, ignoring the market failures and other pathologies that plague it. Even after all that has happened, there is a tendency in Congress and the White House to defer to Wall Street because what happens there, befuddling as it may be to outsiders, is essential to the country's prosperity. Finally, dissidents like Paul Woolley are questioning this narrative. "There was a presumption that financial innovation is socially valuable," Woolley said to me. "The first thing I discovered was that it wasn't backed by any empirical evidence. There's almost none." ♦

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