LOOKING BACKWARD: THE SECURITIES INDUSTRY, A DECADE OF CHANGE

by Eugene H. Rotberg

There has been a lot written recently about the stresses now confronting the securities industry. The media is filled with articles about restructuring, terminations and downsizing, with accompanying finger-pointing and second-guessing of managerial decisions. This article focuses on the pressures over the last decade and how the securities industry responded to competition in a volatile market environment.

Information/New Products/Costs

It started, perhaps, with an information explosion. By the early 1980's, highly specialized data was being made available, not just to securities firms, but also to the man in the street and, more relevant, to the major institutional clients of Wall Street. The technology refined and reassembled data and provided market intermediaries and clients virtually everything one would want to know about companies and markets -- except, of course, what the future would hold, but even that could be had, albeit couched in probability terms. The information systems were expensive to maintain and indispensible to middle men,

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risk-takers, and clients. But, for the first time, clients could work with the same data and research output which heretofore had been available only to their bankers. Once the data and analyses were available, it was only a matter of a short time before clients could implement asset and liability management techniques across a wide range of debt and equity products. By the mid-1980's, institutional managers could evaluate and then invent the most complex products and concepts themselves, in-house. Inevitably, the securities firm increasingly would find itself used primarily for transmitting or executing orders after the client put out what it wanted to do -- often virtually for competitive bidding. Not surprisingly, spreads narrowed and profitability declined.

The information explosion also required paying quite high compensation to so-called "rocket scientists" early on to get it right. Costs escalated in response to an effort to chase relatively few experienced hands. Once one or two firms had the skills, others had little choice but to play expensive catch up. Swaps are not a business for amateurs. Virtually all major firms in the business of marketing and trading had to put in place sophisticated sales, trading and banking capacity to sell the output to a demanding institutional market. It was expensive. The result was a substantial increase in the number of bankers, traders and sales personnel, only recently reduced in the face of declining profits, narrowing spreads and diminishing returns on equity.

A worldwide market for cross-border debt and equity products developed -- the so-called "global marketplace." The securities firms responded to meet a potential, yet unpredictable, demand for a score of currencies. It became necessary, even fashionable, to make long-term and costly offshore real estate and personnel commitments in London, Tokyo and other financial centers. Otherwise, it was thought competitors, particularly local ones, would lock-in previously established relationships with clients who had increasing financial assets to deploy around the world. Firms made these commitments based on projected volumes, spreads and a competitive environment which turned out to be optimistic. The result: further diminished profitability in the face of rising fixed long-term financial obligations.

The proliferation of new products also brought with it considerable disappointments. It was a mixed blessing. Thus, when an aberration in the market was detected, which carried with it the potential for profit, it was usually short-lived. It was quickly identified, thereby diminishing the possibilities for arbitrage. Products also were easily replicated by competitors who, with a bit of tinkering, could change it and offer it to clients as the latest evidence of innovation. This inevitably lowered the potential value-added of the securites firm and put further pressure on profits and spreads - even for the more complex products. Moreover, the products were being developed and marketed by a rapidly-changing and highly-specialized

professional staff, subject to uncertain supervisory and managerial controls and expertise.

Moreover, many of the products made little economic sense. Their attractiveness was usually short-lived and often left a bad taste in the market. Their main advantage was newness and complexity. Inevitably, this led to a sense of diminished confidence between banker and client. The result: securities firms found themselves holding illiquid positions in esoteric products. There is little to suggest, based on recent experience, that the temporary blooms of financial engineering are off the rose or the hedges.

The new products also carried considerable infrastructure costs. Securities firms found themselves in the business of information systems "back office and clearing mechanisms," real estate development, etc. -- business in which they had little expertise and, often, less interest. Costs escalated.

Management: Decisions and Pressures

This is not to say that securities firms embarked on forays into the "global market" from no base of quality or profitable operations. Indeed, many securities firms had niches or franchises developed over many years in which they had marginal or even significant advantage over their competitors: e.g.,

retail distribution, portfolio management, market and industry research, and specialized niches in commercial paper, municipal bonds, block positioning, merchant banking, financial engineering, etc. Most firms, however, typically sought to increase their profitability, not by expanding their base of expertise or their franchise, but rather by entering another firm's "niche," as if it were an infinitely-expanding revenue source which need only be replicated -- by new and untrained personnel. Usually there was no natural fit, and even when there was, it typically was at the technical level, with managerial gaps at the supervisory levels of the firm.

The managerial demands should not be underestimated. The complexity of the products put considerable strain on senior management to evaluate risk and profitability. This, in large part, was due to the fact that there were, literally, scores of complex, highly-leveraged products, painstakingly constructed, for which there was little empirical experience to define and circumscribe the underlying risk. Moreover, even to the extent known (it sometimes was not), the risk profile of the new instruments was too often kept solely within the trading community and operators, and not readily shared with managers. Few firms escaped without damage.

There was also a "center of the universe" syndrome amongst some of the market players. It went something like this: "I must be

able to predict interest rates, exchange rates and market movements; otherwise, why, in a market-based society, am I paid so much to obligate my firm." To make matters worse, there was a lack of symmetry in the compensation system. If the trader wins, the firm and trader did well. If the trader loses, the firm, alone, loses; mistakes were blamed on the "market" or on the pressures from an overly aggressive sales force.

The market players also became used to their style of living. They believed they deserved it. Producers, traders and bankers pressured management for bonuses and virtually unlimited control over expenditures and even risks. Until recently, they had the mobility to move elsewhere. Their products, as it turned out, often did not.

Loyalty of professional personnel was not a given. Indeed, whole business units left one firm for another looking for higher compensation or better financial packages. There was, until the recent restructuring and layoffs, a lot of expensive poaching. Over the decade, securities firms played catch-up to fill the loss of expertise by "buying" market specialists (who often had little understanding of the culture or style of their new firm), to meet the demands of clients or to demonstrate the diversity of the firm's talents. Under the circumstances, it became quite difficult, to put it mildly, for a firm to maintain a consistent external image. By the mid-1980's, many firms, particularly in

London and Tokyo, had an average life of employment of professional staff of less than 18 months, with an age below 30.

Clients also moved around. Many felt little loyalty to new faces. They brought their business to boutique operations, often those with lower infrastructure costs. In an effort to gain or maintain profitability, pressures increased for the quick trade rather than the establishment or maintenance of long-term client relationships. This, too, unfortunately, led to a decreasing sense of confidence and a tilt to an adversarial relationship between the firm and the client.

Proprietary Risk Taking

As it became more difficult to profit from the marketing of replicable products or services, firms began to increase their proprietary risk -- well beyond that dictated by their clients' needs or their sales forces' ability to redistribute. The positioning in inventory of financial assets, by definition, subjected firms to interest rate, exchange rate, event and basis risk. But sales forces had been trained to believe they could sell anything -- quickly. Virtually everything was assumed liquid or poolable -- mortgages, credit card receivables, high yield bonds, corporates, farm loans, mobile homes, etc. These activities required front-end bankers and a sophisticated and dedicated sales force. It was very expensive to maintain, and

there were few economies of scale. Moreover, the sense that everything could be sold lessened subtly the attention to credit quality as the industry assumed that one could always sell off inventory -- indeed, even companies -- quickly to waiting buyers.

Proprietary trading, providing liquidity, making a market -- whatever its name -- generally a virtuous activity designed to fill temporarily the space between buyers and sellers, had varied faces. There always seemed to be a firm or a business unit which was willing to take the place of another, partly out of a sense that they could do it better; partly because of a perceived as yet undiscovered arbitrage; partly from a sense that they owed it to their clients to provide liquidity by "making a market"; partly for the league tables -- the measure of financial manhood; and partly as a straight speculative play. Sometimes for all these reasons -- simultaneously. It made it difficult, to say the least, to measure performance.

Not surprisingly, given the sophistication of the institutional client, as well as the quality of information available, the securities firm inevitably found itself on the other side of the market consensus -- whether in debt or equity products as it tried to provide liquidity for its clients. Such activity, whether voluntary or not, put considerable pressure on the securities firm, particularly since it had nowhere near the resources of its clients to supply that liquidity. Indeed, the

securities firm became increasingly vulnerable in the trading markets as clients inexorably "picked off" dealers with increased sophistication. And when the reverse happened, the client, understandably, took its business elsewhere. The use of options and futures markets, while adding liquidity, in some sense, also complicated the markets and put a great premium on the unique skills of the trader in handling unpredictable events or volatility. And sometimes even when the skills were present, they were diminished by the "center of the universe" syndrome. Modesty was not a characteristic in favor on a trading floor. There is little evidence that these conditions have changed.

The Euro-Market

There were also some fundamental changes taking place outside the United States. The Eurodollar bond market, by the mid-1980's, was already unprofitable. It was subject to destructive price competition, mainly from Japanese institutions, who were prepared, along with one or two others, to "buy" market share by providing bids which simply did not reflect market conditions. Given the high personnel and infrastructure costs, this policy inevitably produced significant losses among most of the players. The result was an irreversible narrowing of spreads across a wide range of debt and equity products. And when a new concept or product was introduced, its replicability was assured by competitors who were by then fully staffed with market and product expertise.

Market profitability, particularly in the international debt markets, also was diminished by several other factors: (a) the high front-end costs in Tokyo; (b) the competition from U.S. commercial banks who, restrained by Glass-Steagall domestically, found an outlet for trading and underwriting through subsidiaries domiciled outside the United States; (c) the competition from European banks, who, with their natural customer deposit base and, therefore, lower funding costs, could suffer (and hide) losses from unsold underwritings for longer periods of time; and, (d) the use of discretionary and/or managed accounts which permitted banks to park or liquidate unwanted inventories of securities -- a process which no reputable U.S. firm could, or would dare to, emulate.

It all inevitably narrowed profit margins as firms sought to improve their rankings in league tables by bidding wars which hurt the first buyers and damaged the reputation of issuers in the process. The underwriters of securities were buried under their own tombstone ads. Indeed, on underwritten offerings, the desire to become a "lead" manager was not so much a matter of prestige or even fees, but simply reflected the need to get a head start, if only an hour or two, before other firms in the underwriting syndicate jammed the switchboards of the relatively few potential buyers.

Nor was it easy for U.S. firms to shift their emphasis to

currencies other than the U.S. dollar. For example, the British government decided to open up the market for U.K. government sterling obligations to over 40 firms. It previously had been restricted to a monopoly given to a quasi-government dealer. The volume was such, however, that profitability could be possible only for a fraction of those firms. Further, the spate of mergers among brokers, dealers, retail and institutional firms in the U.K. virtually integrated the U.K. financial market, making it a far more potent force against those non-U.K. firms who were seeking to establish a foothold. Scottish trusts or insurance companies did not need U.S. firms to advise them about the U.K. equity market.

Merchant Banking

As a result of the developments described above, there were few easy niches or non-replicable value-added services in traditional securities activities. Further, for many firms, proprietary trading had come to be perceived as embodying too much risk for the prospective reward. Firms (sometimes newly formed ones), understandably, turned to merchant banking, a business with a high value-added component and considerable profit potential. It meant firms or business units would direct more attention to mergers, acquisitions, leveraged buyouts, hostile and friendly takeovers, supported by high yield debt provided or found either by banks, the securities firms, or by the recently-deregulated

institutional market in the form of "junk bonds." It was thought to be, perhaps correctly, a quick way to success. The front-end fees to the bankers were substantial, the underwriting commitments for the debt were considerable, and, if the analysis of the company's "real value" was correct, it offered the opportunity for significant return on the accompanying equity investment by the banker.

For some time the rewards for companies and bankers were quite large. But, inevitably the profit potential, again, attracted competition. The fact was, here too, the product was replicable, though, at first, there was a pretense of uniqueness or a monopoly on skill and wisdom. A few unhappy deals have produced a more realistic sense of modesty. Now, the execution of deals, as we are reminded every day, has become increasingly sticky in response to factors outside the control and skills of the originators. Where we are now: (a) deals fall apart because of lack of financing; (b) the Fed has signaled the banking system to cool their participation in providing front-end support for highly leveraged buyout transactions; (c) there is concern about the prospects for regulatory or tax action which would restrict hostile takeovers by denying the interest deduction for the underlying debt financing; (d) the savings and loan industry has been pressured to divest, or not to increase new holdings of high-yield paper; (e) it turns out that there is an almost "captive" institutional market, increasingly nervous, which has

comfortable ties only to a few firms; (f) criminal indictments have cast, not unexpectedly, a pall on the whole business and raised the spectre that the business cannot be done, at least with the success of the past, within the confines of the law and/or propriety; (g) increased regulatory oversight by the insurance industry over the deployment of assets has weakened the demand for the debt; (h) competition and the requirements imposed on directors to seek the "best" have pushed up prices; (i) voluntary restructurings involving more efficient use of cash divestitures and increased debt have slimmed the pickings; and (j) the Japanese are now more reluctant players, after some highly publicized losses. The net result has been a significant decline in the market value of high yield paper, generally purchased by fiduciaries holding other people's money. They are now much more cautious. In short, it has become, rather quickly, a quite difficult market.

The Banks and Competition

Securities firms do not compete only with each other. The banks, S&Ls, and insurance companies also compete with securities firms for assets, market share, agency business, bridge loans on leveraged buyouts, etc. These financial institutions have some advantages, partly because of accounting conventions and partly because of the nature of the resources at their disposal. The bottom line is that they can take present pleasure for future

pain. Thus, savings and loan institutions and banks took on fixed-rate assets, e.g., bonds or mortgages at, say, 2% over floating rate liabilities; used insured deposits for illiquid investments; deployed assets on highly leveraged financial instruments; invested in unimproved property or unproven and speculative ventures, etc. The truth is many did not really worry about interest rate or maturity mismatches, or the quality and character of their "hedges," or even changes in the real value of their new assets -- which were not marked to market. Loans and investments were kept on books at par long after their value was impaired. Deregulation permitted them to hold assets with little liquidity and funded with minimal equity participation. Their conservators would have to pick up the pieces. Nor has the system changed -- even now. Unlike securities firms, the banks and the S&L's still finance themselves in the depositary markets through the use of federally-insured funds. They still can put illiquid assets -- both debt and equity -- on their books, and then restructure loans, which are maintained at par, if difficulties are encountered. The concept is straightforward: a rolling loan gathers no loss.

It is not an environment which encourages prudence -- not for banking institutions because they can hide mistakes on the deployment of their assets and use federally-insured deposits as the source of capital, and not for the securities firms, who

inevitably compete with them for mandates -- often those with high potential returns (and accompanying risks) to offset the narrow spreads and high costs in their traditional lines of business.

Credit standards have deteriorated -- the natural consequence of a system which does not recognize a credit risk or failure unless it is recorded on the books. The unhappy reality is that an accounting system which does not mark loans or assets to their market value, until sold, inevitably encourages flawed decision-making -- both for banking institutions and for securities firms. A system which provides government insurance and deregulates the deployment of assets, permits financial institutions to avoid a "market" test and to expand into a wide range of new markets and products was bound to run into trouble -- particularly given the minimal equity capital commitment of the owners. Quite apart from the damage to their shareholders and to taxpayers, another result was to increase the pressures on a highly visible and regulated securities industry. The system simply has provided an incentive for risk taking by one set of financial intermediaries in their endeavor to compete for assets, engage in proprietary trading, and engage in lending or merchant banking activities. It is not a healthy environment, or one which might be expected to encourage managerial prudence. Financial intermediaries of all types either have had to offer a higher return, better prices, or convenience in order to gather

assets and obtain mandates. It was and is expensive. It inevitably puts pressure on all financial intermediaries.

The securities firms are not blameless. For two decades, they have invented and refined a wide range of products for themselves and their clients which have had the effect of shortening the maturity of debt and leveraging it. Everything seems to float. Credit evaluation, too often, has taken a back seat to providing liquidity as if the former were unnecessary if the latter were assured. But liquidity is never assured, particularly where the same quality information is being processed simultaneously by relatively few and sophisticated market players. The credit specialists are the nay sayers, an unpopular lot at best.

Government Policy

Government policy has also been a factor. Volatility has increased, particularly in the debt markets -- the result of (a) the unfixing of exchange rates; (b) the deregulation of cross border investments; (c) the use of interest rates as a monetary tool; and (d) the impact on U.S. dollar interest rates of the rates in other countries. Not surprisingly, the volatility in the long term bond markets in a given month by the late 1980's was as great as the entire volatility in these markets in the period 1955 to 1965.

Official policy also has resulted in negative yield curves, i.e., the condition when short-term financing costs are higher than the return on the assets purchased. It makes even modest position-taking a perilous undertaking, given the negative cost of carrying positions. In addition, frequent and unpredictable announcements in Tokyo, London and Washington have created significant and negative event risks -- few are positive -- which have caused market losses and eroded even those narrow profit margins which were painstakingly developed: e.g., tax policy vis-a-vis municipal bonds; on again/off again capital gains proposals; exclusion of "perpetuals" as capital for commercial banks; volatile foreign exchange markets; restrictions on the use of bearer bonds in the Eurodollar markets; legislation considered, then withdrawn, on the applicability of withholding taxes; "administrative guidance" suggesting a more modest investment by Japanese in U.S. dollar- denominated assets; legislative hearings limiting deductibility of interest on hostile takeovers; and on and on.

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It has been a decade which tested every firm and which has put great pressures on the management of uncertainty. The handling of uncertainty is not a skill which easily comes to managers who do not easily admit to vulnerability or unsuredness. Many, in their heart of hearts, believe that management is a bit

inconsistent with the cliche that "the market is always right." So, a lot of firms mostly just went with the flow.

The key now, I suspect, is simply to manage and ask, openly and directly, some rather ordinary questions: (a) where and how can the securities firm provide substantial and not easily replicable value-added services; (b) with whom, if anyone, can shared expertise enhance those special franchises or skills; and, of course, (c) what kinds of activity in the 1990's are likely to produce benefit to clients and stockholders, and with what kind of risks. The answer to that one will be the subject of the next, far more upbeat, article.