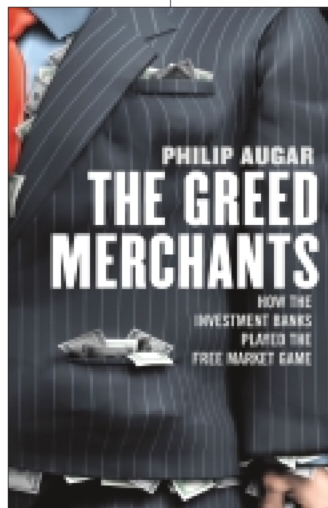
By Aaron Brown

The Greed Merchants:
How Investment Banks Played the Free Market Game

Author: Philip Augar
Publisher: Harper Collins, April 2005 **ISBN:** 1591840872

This review was written by **Aaron Brown**, a vice president at Morgan Stanley who spends most of his working hours converting credit risk models and systems to Basel II standards. Brown, a member of GRR's editorial board, also performed an interesting one-on-one interview with Philip Augar (see "A Conversation with Philip Augar," pg. 9).

This is a book that requires careful reading. The back cover reads, "Are investment bankers the responsible guardians of free-market capitalism that they would have us believe? Or are they something more sinister altogether, necessary but dangerous players in our free-market economy?" This provides the first hint that Philip Augar's tome is not a typical one-sided diatribe on Wall Street. After all, what kind of financial critic thinks investment bankers are necessary? Or, looking at it the other way, what kind of fan of investment bankers also thinks they're sinister and dangerous?



In the recent past, other books have provided moderate and nuanced accounts of individual financial disasters: Roger Lowenstein's ***When Genius Failed*** is an outstanding example. But when writers take on Wall Street as a whole, they tend to extremes. Frank Partnoy is probably the most knowledgeable critic (*F.I.A.S.C.O.* and *Infectious Greed*), while Peter Bernstein (*Capital Ideas*) is an example of a fine writer who seems pretty happy with the way things are. But *The Greed Merchants* is a rare middle-of-the-road book.

Philip Augar starts out with a two-chapter summary of the problems of financial institutions (*The Trusted Advisor Takes a Fall* and *The Age of Deception*). It is a concise and incisive treatment, but the embarrassments will be familiar to most GARP readers. Unlike a Partnoy, however, Augar gives careful attention to the limits of the offenses and treats the cleanup efforts with respect. He delivers a balanced judgment, noting that while scandals come with hot markets, there are countervailing forces that clean them up and limit the total damage they can do. The real problem in the long run is systemic behavior that makes investment banking seem like a cartel.

The next section of the book is a careful look at investment banking. Firms make lots of money, and use about half of it to overpay their employees. The good ones have developed a business strategy that provides low-risk profits and insulation from competition. Whether that's praise or criticism depends on whether you work for an investment bank or pay for their services. After careful sifting of the evidence, Augar concludes that no illegal cartel exists, but that the top firms enjoy substantial oligopoly benefits.

There is a similarly balanced account of the quality of investment banking services. In many cases, Augar argues, it leaves a lot to be desired. Firms facilitate mergers and other corporate actions that destroy shareholder value, take both sides in transactions while claiming to act in both clients' best interests and often give poor advice. In other cases, however, investment banks deliver superlative service that is worth far more than the fees charged.

Addition by Division

Augar suggests that the solution is not to destroy investment banks or to worship them, but to break up the businesses into corporate advisory (including underwriting), proprietary trading and asset management and analysis. This will allow the banks to continue to provide their exceptional services, without the conflicts and excess prof-

its of the current system. While the book does not go into details about how this will happen, it seems clear it will require tough legislation, since banks will not give up their comfortable and profitable positions voluntarily. Change could also come from investors demanding better quality at a lower price, but there is no evidence that is happening.

In the course of making this argument, the book divides the top investment banks into three groups. The pinnacle is the superbulge, Morgan Stanley, Goldman Sachs and Merrill Lynch. These are "the firms to beat if you are a competitor, the firms to work for if you are an investment banker, and the firms to hire if you are a [client]." Good management (including risk management), strong culture and talent have kept these three at the top of the industry for 25 years.

The next three firms — Lehman Brothers, Citigroup and CS First Boston — make up the "impossible to kill" category. They aspired to the superbulge, but were almost destroyed by scandal. And the lingering aftereffects have kept them just below the top. Four other firms, says Augar, round out the top companies: JPMorganChase, Deutsche Bank, UBS Warburg and Bear Stearns. But these are niche players compared to the higher rated firms.

Many readers will find this book valuable just for the capsule histories of these firms. Since the book is so moderate and charmingly written, it's also easy to accept Augar's arguments uncritically. But if you resist this temptation, you have to ask why such a low-risk business saw so many firms destroyed over the last 25 years. Kidder Peabody, Barings, Bankers Trust and Drexel Burnham, to name the four most dramatic examples, did not quietly slip into bankruptcy; they collapsed amid criminal charges and gigantic civil suits. None of the people I know who lived through the final days of all four firms would describe investment banking as low risk. Moreover, there are hundreds of other firms that went out of business — or merged on unfavorable terms — more quietly.

The question is whether the 10 successful firms above were better than the failures or just luckier. If the latter, then the business is risky and looks safe due to the selection bias of looking at only winners. I think most people will agree that Goldman Sachs' top management knew more about the business than Kidder Peabody's and that Merrill Lynch had better controls than Barings. But Bankers Trust certainly had better risk management than Salomon Brothers (now part of Citigroup), a less aggressive culture (if only by a hair), and far more capital. Drexel pushed some envelopes, but so did First Boston (now part of Credit Suisse).

Compensation Controversy

Augar also discusses compensation, arguing that investment bankers make too much money. But if investment bank employees are so overpaid, why do they seem to have little trouble finding equal or better pay in other businesses (hedge funds at the moment, technology companies a few years ago)?

By any standard of human fairness, of course, investment bankers make obscene amounts of money. But by the capitalist standard, they seem to be at their market-clearing price. Also, compared to 25 years ago, the profession has opened up to a wider variety of people. When I started on Wall Street, it was more homogenous than the students at an Ivy League university. Now it's substantially more heterogeneous. That doesn't mean everyone in the world is born with an equal chance of becoming a managing director at a top firm, but against a relevant yardstick, the benefits are being shared more evenly than in the past.

Although the author cites many clients claiming that investment banks overcharge and uses this as evidence of informal price-fixing, all the clients paid the price demanded. No one cuts prices if the customer is willing to pay. The test of price-fixing is companies willing to lose sales to maintain the higher price.

Of course, in an effective oligopoly, the customer will end up paying the same high price somewhere else or doing without. But if no one even switches from one firm to another, there's no reason to suspect collusion. I think buyers of almost any good or service complain about the price.

This leads into another problem with the book: reliance on anonymous sources. About half the evidence in the book consists of private interviews with unnamed people. If the book were written by an outsider, this would be a crippling defect. However, because the author is the former head of a bank (Schroders Securities), he obviously has contacts with top people and can understand and evaluate information from insiders. Still, it's easy for an honest author to unconsciously slant material, including everything that supports his thesis, and editing out everything that does not.

While investment banks seem arrogant in keeping prices high, they're no different than most high-end suppliers. You won't have much luck bargaining at an expensive retail shop or getting the most valuable athlete or hottest movie star to work cheap. Competing on quality, not price, is a standard business strategy. There are price competitors for most investment banking services, including, certainly, all the retail and consulting services. What's more, some firms take corporate services in-house.

The fact that there are two sides to this argument is no reason not to read this book. It's a hugely informative insider's account. It achieves the rare balance of being simultaneously provocative and moderate. Whether you agree with it or not in the end, the thoughtful analysis will deepen your understanding of the investment banking industry and how it is likely to evolve in the future. > > >

A Conversation with Philip Augar

Aaron Brown (AB): *How does **The Greed Merchants** relate to your 2000 work, **The Death of Gentlemanly Capitalism**? Is this the murderer's story?*

Philip Augar (PA): That's an interesting angle but, no, the US banks were not murderers; the death [of gentlemanly capitalism] was to a large degree self-inflicted. British managers, regulators and the government, in the run up to the Big Bang,[1] underestimated how complex the task was. There was a degree of mismanagement as well. Simultaneously, US banks were hovering on the scene; beefing up risk management skills; learning how to take full advantage of the integrated model.[2]

AB: *You note the conflict of interest when financial institutions underwrite and sell corporate securities. They should want to get as high a price as possible for the corporate issuers and as low a price as possible for the investor customers. But how is this different from any business — say a car company — that makes and sells a product?*

Philip Augar

PA: Investment banks make quite a bit of noise about trust, dealing only in the client's best interest. You cannot simultaneously serve the interest of issuer clients and investing clients. And it's not just underwriting and sales; investment banks run proprietary trading operations that are also making a profit out of these securities.

AB: *You point out that salaries in investment banking have grown much faster than pay in other professions since 1980. But hasn't the skill set changed as well? We didn't have many physics PhDs in the business in 1980.*

PA: There's no doubt the increased need for technical skills explains some of the adjustment. Also the hours are more demanding today; there is more pressure. But these same factors affect other knowledge workers whose pay has not risen as sharply.

AB: *To GRR readers, your most provocative claim is that investment banking is not as risky as it looks. Most of us spend our working hours trying to convince people of the opposite.*

PA: Despite all the ups and downs, you see the same three banks[3] on top for the last 25 years, in large part due to superior risk management. It is as a result of the efforts, skills and improved status of risk professionals — as well as the edge that investment banks get as a result of their strong market position — that the business as a whole has been less risky in recent years than you might have expected, given the market's volatility and the size of individual transactions.

In the older model of independent businesses, firms used to go broke all the time, whenever there was a structural change in the economy. The industry itself is risky. But the top firms always managed to pull all the dots together.

The integrated model only worked big time after 1993. That was when we learned risk management was not a spare time activity. The professionalization of risk management makes the integrated investment bank possible.

AB: *So what should the next generation of investment banks look like?*

PA: My concern is with the combination of trusted advisor and execution services. I would like to see corporate and investor advisory work step outside the integrated model. Customers should squeeze harder on prices. Proprietary trading should be done by well-capitalized, independent trading institutions.

AB: *Hedge funds without the leverage?*

PA: Something like that. But with more transparency.

AB: *What are you doing now?*

PA: My full-time financial career ended in 1998; I worked part time in 1999 and 2000. Now I am a writer and teacher.

FOOTNOTES:
1. A radical reorganization of UK stock markets in 1986, similar to the US elimination of fixed stock commissions on "May Day" in 1975.
2. Combining a full suite of institutional and retail products in one organization.
3. Morgan Stanley, Goldman Sachs and Merrill Lynch.