What's Still Wrong with Wall Street

BY ALLAN SLOAN

ARE YOU FURIOUS? IF NOT, YOU should be. The giant financial institutions that make up Wall Street have been bailed out, thanks to trillions of dollars of our money, and are on track to hand out record-breaking multibillion-dollar bonuses while millions of regular folks are hurting. Even outside the gilded halls of Wall Street, there's no shortage of good cheer: many economists say the great Recession has ended, and Federal Reserve Chairman Ben Bernanke keeps seeing "green shoots" in the economy.

But the only green shoots that many non–Wall Street types have seen lately are the weeds sprouting in the parking lots of abandoned malls. Unemployment is marching toward 10%, and house foreclosures are still rising. If you're a day late with your credit-card payment or overdrawn by a few bucks on your ATM card, the bank (which your tax money helped bail out) is still sticking you with obscene fees and charges. Hence the question that so many of us are asking: Where's my bailout?

Welcome to Round 2 of Main Street vs. Wall Street. The divide is the worst I've seen in my 40 years of writing about finance. In a new Time poll, 75% of the respondents say they believe Wall Street will revert to business as usual, 67% want the government to force pay cuts, and 59% want more government regulation.

Main and Wall are never going to love each other. And they probably shouldn't, because their interests aren't identical. But if we're going to get through this mess as a society and regain our prosperity, Main Street and Wall Street need to understand each other. And they don't.

Too many people on Wall Street are acting in an arrogant, clueless and tone-deaf way, huffily treating any criticism of their pay and practices and perks as an attack on the free-enterprise system. Wall Street-ers like to say (and may even believe) that they're helping humanity—which occasionally happens, but only by accident—rather than being out to make the most money they can.

Without a doubt, the financial meltdown and its ensuing horrors began on Wall Street. However, Main Street is not a totally innocent lamb in all this. Yes, the greedheads tempted us with mortgages and other products we couldn't afford. But you could have said no, as many of us did. And you could have tried to live within your means or, better yet, below them, instead of falling prey to financial fantasies.

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WHO'S TO BLAME?

While it feels great to be outraged by these fat bonuses and whack the pigs by restricting—or seeming to restrict—the pay at outfits that have taken government bailout money, it's a bit pointless too. Because to some extent, Wall Street's pay and its problems really are misunderstood. (Stop snickering! It's true.) Even though "Wall Street" means the nation's big financial and investing operations, not a geographical location, a disproportionate number of Street people live in Manhattan. Things in the desirable parts of that borough are expensive beyond belief, especially if you have
67% want the government to force pay cuts on top executives at the Wall Street firms that received government bailout money.

How much were you personally hurt by the economic downturn in the past year?

- Great deal: 23%
- Some: 44%
- Not much: 22%
- Not at all: 10%

36% think their own personal economic situation has gotten WORSE over the past 12 months.

58% think Wall Street has had too much influence over the government's economic recovery policy.

77% don’t think the government’s recovery has helped them.

However, 60% think the government did what was necessary to avoid a bigger crisis.

75% think the large financial institutions didn’t learn from their mistakes and will return to BUSINESS AS USUAL.

How good a job would you say the following are doing in taking steps to avoid another financial crisis:

- President Obama: 10%
- Democrats in Congress: 30%
- Republicans in Congress: 50%
- Banks and Wall Street: 70%
- Government regulators: 90%

57% said the government interfered with privately owned businesses.

But would you have personally suffered if the government had allowed the banks to fail?

- Yes: 71%
- No: 29%

71% favor putting limits on salaries of Wall Street executives, but Americans are divided on whether to put a higher tax on bonuses.

children and feel the need to send them to $40,000-a-year private schools. But these people choose to live in Manhattan.

In the real world (outside New York City), a bonus is generally a payment for extraordinarily good performance. But on Wall Street, what's called a bonus is generally part of base pay. That's especially true for worker bees, who far outnumber CEOs. (The word bonus is a remnant from the days when Wall Street was made up of partnerships. Now that Wall Street's largely owned by public shareholders, it should have long since dropped bonus for contingent compensation or something similar. But hey, the Street, as I said, is tone deaf.)

Paying a $25 million or $30 million bonus to a Goldman Sachs or JPMorgan Chase or Morgan Stanley higher-up this year is obscene because none of these firms would exist if our government and others hadn't stepped in to save the world financial system. If these companies have all that money, largely courtesy of us, they ought to send it to the U.S. Treasury. But paying a $250,000 bonus on top of a $150,000 salary to a worker bee is a different story.

More important, at least when it comes to the bailed-out businesses, the notion that there's a correlation between excessive pay and excessive risk-taking isn't quite accurate. It may be true in the case of hedge funds or leveraged buyout—which call themselves private-equity (PE)—firms or some parts of stricken outfits like AIG, Citi and the former Merrill Lynch,Steve Feinberg's takeovers. But paying a $25 million or $30 million bonus to Goldman Sachs CEO Lloyd Blankfein is another story.

The Merely Rich

The Megarich

The top 1% of American taxpayers each paid an average of $11.5 million a year. This group—making more than $1 million a year—controlled more than 57% of all income and 75% of all capital gains over the past 30 years. In 2007 the top 5% to 10% of earners had adjusted gross income of $220,105, while the top 1% to 5% of earners made more than $220,105. The top 1% of earners, making more than $1.4 million a year, accounted for more than 0.01% of all income. Other earners in the top 10% of the income distribution earned $128,560.

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The Megarich
In 2007 the top 0.01% consisted of 14,588 taxpayers making more than $11.5 million a year. This group controlled more than 6% of all U.S. income.

Other earner averages in 2007
Top 1% to 5% $220,105
Top 5% to 10% $128,560
Bottom 90% $32,421

Average annual income, adjusted for inflation

$5 million

Great Depression
World War II
Vietnam War

The Merely Rich
The top 1% of taxpayers each made at least $398,900 in 2007

$1.4 million

Note: Figures include capital gains.
Source: Income-distribution analysis by Thomas Piketty and Emmanuel Saez using tax data.

...money in esoteric securities rather than in risk-free Treasuries, the standard practice. The idea was—I'm not kidding—to make an extra one-fifth of 1% in interest. When the esoterica, which the stock-loan folks thought was riskless, crumbled, so did the firm.

The likes of Citi owned AAA-rated mortgage securities they thought were as safe as Treasury securities. That's what AAA means—or what they thought it meant. But since the rating agencies screwed up royally by not analyzing the securities properly—a whole other story—Citi et al. got whacked.

Don't forget, too, that a fair number of Wall Streeters got wiped out because their wealth was tied to their firm's stock price. Dick Fuld, the former CEO of Lehman, had shares and options worth about $1 billion at their peak. He got less than $1 million when he sold them after the firm went bankrupt. (He still took home, before taxes, $490 million from his stock-based compensation, so don't cry for him.)

James Cayne, CEO of the defunct Bear Stearns, was in a similar situation. If Fuld and Cayne had known their firms were as badly at risk as they proved to be, don't you think they'd have sold as much stock as they could before their firms imploded?

In the end, the problem isn't really pay; it's competence. The CEOs didn't understand the fine print. These firms collapsed out of ignorance fueled by avarice—a particularly toxic combination. Under the circumstances, Feinberg is doing the best he can. But what he's doing is more symbolic than real (although symbolism does matter). Meanwhile, genuine reform of the financial system is bogging down. Wall Street wins again.

The Real Bailout
Some bankers now have the attitude of, What's the problem? The crisis is over. Get out of our way and let us get back to business. This is especially true of those who don't owe the government any money. The conventional thinking is that the $700 billion of Troubled Asset Relief Program (TARP) money was the beginning and will be the end of the bailout. TARP lent $238 billion to more than 680 banks, according to SNL Financial, a research firm; 44 of these banks have repaid a total of $71 billion. Thus, there's less than $170 billion, a relative pittance, of TARP money invested in banks.

So when the likes of Goldman Sachs or JPMorgan Chase, which were well capitalized and well run, say they didn't really need TARP money in the first place, that's more or less accurate. However, that doesn't mean that Goldman, JPMorgan...
and every other bank in the country weren’t bailed out. Had the world economy melted down and more giant institutions failed, even strong firms like Goldman would have gone under.

In July, Goldman acknowledged this, more or less, when it graciously—yes, graciously—paid a full price of $1.1 billion to redeem stock-purchase warrants it gave the government for lending it $10 billion of TARP money.

Indeed, these banks ought to acknowledge that the government saved them. For starters, they ought to stop gouging the vulnerable among us with overdraft fees and credit-card games. “Reform” is supposed to take effect early next year, but banks have accelerated their gouging since the legislation passed.

In a more macro way, Goldman and Morgan Stanley in particular were facing the equivalent of a bank run in September 2008, as fear-stricken hedge funds for which they were prime brokers pulled out their assets. The firms would have been toast if the government hadn’t allowed them to become bank holding companies overnight, giving them access to almost unlimited funds that the Federal Reserve makes available to banks.

So, you see, the real bailout wasn’t TARP. It was lending and guarantee programs from the Fed and the Federal Deposit Insurance Corp. The Fed had a mere three borrowing programs before the crisis started in the summer of 2007, when two Bear Stearns hedge funds failed. At the height of the bailout, there were no fewer than 13 programs. The New York Fed had to post them on its website sideways, using teensy-weensy type, so they would print out on a single sheet of paper.

Main Street has paid a price for the ultra-low interest rates the Fed has kept in place to encourage banks to lend and to keep commerce flowing. Cheap money is nice for lenders and borrowers—but it’s devastating for savers, especially for retirees who use interest income to supplement Social Security. If you had $500,000 stashed away—not a bad nest egg—you could earn a no-risk $20,000 to $25,000 annually (before taxes) two years ago buying bank CDs or short-term Treasury securities. Now you earn less than $5,000 in an average one-year CD, about $2,000 in a one-year Treasury. This offers retirees unpleasant choices: reduce their standard of living, eat into their principal or take greater risks to restore the lost income.

**Where’s the Justice?**

Of none of the people who presided over the catastrophes at the likes of Citibank and AIG and Merrill Lynch are likely to go to jail. That’s because incompetence and arrogance aren’t criminal offenses. If that seems a bit unfair, so does the government’s rescue program that saved some and not others, depending on political and social criteria. The most recent example: Delphi Corp., GM’s former parts division that was spun off a decade ago, which recently emerged from bankruptcy proceedings. White-collar Delphi retirees are having their pensions whacked, but United Auto Workers pensioners are being made whole.

That’s harshly arbitrary, as is the fact that UAW jobs have been saved, at least for now, thanks to $60 billion of government money flowing into GM and Chrysler. Meanwhile, other companies have been allowed to croak. I can see how on macroeconomic grounds, it makes sense. Letting GM and Chrysler go under would have devastated the industrial Midwest and deprived millions of retirees of their postemployment health care.

But if I were a white-collar Delphi retiree, I’d be over the moon with rage. Ditto if I’d been a steelworker in Pennsylvania whose health care and pension were eviscerated when Bethlehem Steel failed. If I worked at one of the 106 non-giant banks that the government has allowed to fail this year, throwing thousands of people out of work, I’d be furious at the government for saving the big insolvent outfits but not mine.

And what about those bankers? Just because I’m not proposing we immediately hang everyone on Wall Street from the highest tree, don’t think I’m a Street symp.

Make no mistake; I’m livid at the Street, which is inflicting pain on people who don’t deserve it and ruining things for moderates like me, who believe in markets but with intelligent regulation. And did I mention gouging people before new credit-card rules come in? I did. It’s an outrage.

I’m also angry because it’s hugely difficult for even the most qualified people to get loans. Not to mention how hard it is for small and medium businesses. Having lent too much too easily, banks now don’t want to lend at all—except to Uncle Sam.

In fact, much of the money that taxpayers have pumped into the financial system has ended up at banks that are lending it back to the government by buying Treasury securities. Isn’t that great? We make money available to the banks at 0%, they lend it to the government at a markup, and they make money off our tax dollars, whining every step of the way.

Then there are the blinders. Goldman Sachs, everyone’s favorite piñata these days, explains that its bonus pool is so high because it sets aside half its profits for compensation (which includes salaries and benefits as well as bonuses).
Other firms have similar formulas. Well, excuse me. This isn’t a normal time or a normal year. Just because you’ve done something in the past doesn’t mean you have to do it now.

Firms could take care of the people down their food chain but allow the people at the top to go without bonuses again. Instead of doing that, it’s going to be business as usual.

People who grab every penny they can, using taxpayer money, aren’t true capitalists. True capitalists are long-term greedy, trying to maximize their take over the long run. The short-term greedy aren’t capitalists, they’re pigs. And as they say on Wall Street, pigs get slaughtered.

**How to Fix It**

**1) Break up institutions that are too big to fail so that we can allow them to fail.** I don’t know exactly how to do this—does anyone?—but that’s how we solve the problem of letting the small fry fail while saving the wounded whales. Perhaps, as many have urged lately, we can start by reviving elements of the Glass-Steagall Act that kept old-fashioned banks out of the far riskier investment business. And out of big trouble. As we’ve seen, most of the giant rescued institutions didn’t understand their problems until it was too late, so how do you expect a regulator to see trouble coming?

**2) Tell the truth, and play it down the middle.** Yes, demonizing others—“pointy-headed liberals,” “Wall Street pigs,” “socialists” or Fox News—is satisfying and helps mobilize the demonizer’s political and ideological base. It also helps the demonized do the same. But divide-and-hope-to-conquer is horrible social policy, and we ought to shun anyone, from “senior officials” to Fox News to MSNBC, who does it.

**3) Put not your faith in the Fed or Uncle Sam.** During the 1982-2000 stock-market boom and the long economic expansion, people foolishly began to think that government officials like former Fed Chairman Alan Greenspan (formerly the “Maestro” and the man who helped save the world, now Alan Who?)—were looking after their interests. They weren’t. Greenspan’s job was to protect the world financial system and the economy, not you. Ben Bernanke’s job is the same as Greenspan’s.

**4) And for heaven’s sake, don’t put your faith in Wall Street.** Never, ever. Left to its own devices, the Street will go to excess, as we’ve seen from two bubbles (tech stocks and houses) that have burst within the past decade and two more that are in the process of popping: commercial real estate and leveraged buyouts. Even though there are plenty of decent people on Wall Street, the Street’s primary interest is its own well-being, not yours. Don’t forget that. You’d better take care of yourself, because there’s no one else to do it.