Forbes

Goldman Sachs Employees Can, And New York Fed Regulators Can't

By John Tamny

October 6, 2014

In his recently released book, The CEO Tightrope, Joel Trammell made plain what is all too often missed about the individuals who work on Wall Street: they're wildly talented. That's why the pay in finance has the potential to be so impressive. As Trammell recalled about his own attempts to raise money for his various successful technology start-ups:

"I'll be honest: my track record for providing capital is not great. Raising money is hard (my emphasis). Over my career of leading multiple companies, I have talked to more than a hundred institutional investors and have reached a deal exactly once. For this reason I advise companies to take the money when they can, because it often isn't there when you really need it."

The pay in finance is high because those who work on Wall Street are capable of doing what some of the best CEOs freely admit they're not very good at. Businesses compensate investment banks in grand fashion not because raising money for expansion is easy, but precisely because it's very difficult.

What does this have to do with the "scandal" du jour about Goldman Sachs and its dealings with regulators at the New York Fed? Well, it really has everything to do with it. The problem is that the simple notion of talent hasn't much informed the alleged scandal so far.

One financial-sector skeptic comically described it as a "jaw dropping story about Wall Street regulation." Presumably wiser minds have responded that there's not much to the scandal, that "regulatory capture" whereby those regulated exert powerful control over their regulators is the real story. Much ado about nothing as it were, not to mention that some regulators oversee banks lightly with an eye on eventually securing higher-paying work with those same banks and investment banks.

It says here that both sides miss the point. Figure it's shooting fish in the most crowded of barrels to talk about regulatory capture. Of course the latter prevails. As is well known, the Fed was created 100 years ago not so much to regulate banks as to provide a source of finance for money-center institutions during periods of tight credit.

As for regulators overseeing banks with a velvet glove with future employment in mind, the reality is that they work at the Fed and in other regulatory bodies often because they couldn't get jobs on Wall Street. About those who toil at the Fed, Cato Institute president and former BB&T Bank CEO John Allison wrote in The Financial Crisis and the Free Market Cure that "In my career, the Fed has a 100 percent error rate in predicting and reacting to important economic turns."

What Allison's recollection tells us very brightly is that most Fed drones wouldn't rate a Wall Street job in a normal world. To the extent that Fed bureaucrats are hired into finance, it's not for their keen sense of the markets as much as they're employed for their knowledge of what the credit-destroyers inside the Fed will do in the future. That's hardly an endorsement of those who word at the Fed, but it better explains why regulators at the New York Fed have treated Goldman and surely others in such light fashion.

Returning to Trammell's experiences raising money, the real story about Goldman and New York Fed is one of talent. Fed regulators employed and employ a soft approach to the investment banks simply because they at least implicitly recognize a massive talent mismatch. To presume that Fed regulators have the skill to effectively oversee Wall Street is the equivalent of assuming that Florida Atlantic will beat Alabama in football on a regular basis. In truth, FAU lost 41-0 to Alabama in September, and so long as the two teams play, lopsided scores like the one from last month will be the norm.

FAU's loss to Alabama explains the New York Fed's worshipful treatment of Goldman, and it also explains why regulation is worse than superfluous. Fed regulators are the FAU Owls equivalent. The Owls aren't good enough to beat the Crimson Tide, and regulators aren't good enough to successfully keep financial institutions from committing their inevitable mistakes.

Regulation presumes equality between regulator and financier that logic dictates does not exist. Allison notes in speeches a variation of the truth that "government can't possibly make us all equal, but it can make the talented small." Regulations on their best day don't achieve their stated objective of making financial institutions healthier (figure the banking sector remains one of the most regulated in the U.S., yet those same regulators didn't have a clue about the problems within banks back in 2008 until private market actors discovered them – think John Paulson among others), but they do succeed when it comes to distracting those same institutions that are in the business of attaining profits.

That's of course what's so puzzling about some of the solutions offered from those who properly understand that applied to Goldman and the New York Fed, there's no story. One editorial from a newspaper that didn't describe Goldman's dealings with the Fed as "jaw dropping" offered up

15% bank capital requirements as an alleged fix for the troubles that sometimes reveal themselves inside financial institutions.

The above response is easily as flawed as the one that says banks need more regulatory oversight. Explicit in high capital requirements is reduced profits for banks, and as a result, lower pay for those who work inside them. Missed there is that well-run financial institutions never run out of money, and can always use their balance sheets to attain credit during short-term pinches.

High capital requirements are the equivalent of the conceit that says increased regulation will equalize that which presently isn't. It won't, and capital requirements will only work in the unfortunate sense that barriers to profit will drive the talented away from banks, thus making future mistakes more, not less likely.

What this tells us is that there's only one solution to the alleged problem of errant banks: total deregulation, and a statement from the feds that bailouts will never happen again. Notably, the latter should apply to Goldman, which was able to become a "bank" very quickly back in 2008 so that it could attain relatively cheap Fed funding. If so, the market actors that discovered problems in the banks to begin with will enforce better management on the part of financial institutions. Anything else will only succeed insofar as it perpetuates the problems that regulations were naively – and unsuccessfully – imposed to erase.

The real story of Goldman Sachs vis-à-vis the Fed is once again one of talent: Goldman employees can, and New York Fed regulators can't. Naturally those who can't will have a reverential countenance around their financial betters, and until this is realized, the audio recordings that have so many up in arms will remain the logical norm.