BOOKSHELF | By Burton G. Malkiel

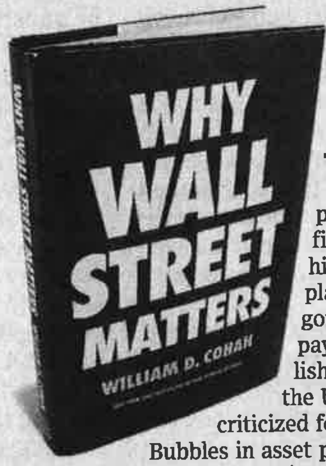
Big Bonus, Big Problem

Why Wall Street Matters

By William D. Cohan
(Random House, 154 pages, $25)

Ever since the crisis of 2008, banks have been subject to ferocious attack and more regulation. In "Why Wall Street Matters," William Cohan, the author of earlier books on Goldman Sachs and Lazard Frères, mounts a defense of Wall Street banking institutions and argues that much of the regulation after 2008 has been counterproductive. In his view, the main culprit in the financial meltdown was Wall Street's compensation culture, and he presents some controversial proposals to reform it.

In the recent election campaign, as Mr. Cohan notes, the Democratic Party platform called for breaking up large Wall Street banks. Even the Republican platform called for separating commercial and investment banks. Since the election, Sens. Bernie Sanders and Elizabeth Warren have lambasted Wall Street and decried the inclusion of so many Wall Street executives in the Trump administration.



Mr. Cohan reminds us that populist hostility toward the financial community has a long history. Alexander Hamilton's plan to have the federal government guarantee the full payment of its debt, thus establishing the unquestioned credit of the United States, was sharply criticized for rewarding evil speculators.

Bubbles in asset prices and financial crises have been common in American history; so has rage against financiers. A wagon loaded with dynamite exploded at the corner of Broad and Wall Street in 1920. Franklin Roosevelt savaged Wall Street in his first inaugural address.

It is in this context that Mr. Cohan explains the role of finance in the modern economy. The collective institutions that constitute "Wall Street," he notes, provide a "monumentally important, utterly irreplaceable" service. Indeed, the ability of companies "to get the capital they need from the people who have it and want to invest it is one of the more amazing contraptions that the world has ever constructed." Companies such as Apple would not exist without Wall Street. The securitization of otherwise illiquid individual mortgages in mortgage-backed securities provides more money for housing and lower mortgage rates. The securitization of auto loans makes financing easier for car buyers. The "junk bond" market allows businesses without perfect credit to obtain capital. The "democratization of capital," Mr. Cohan writes, "has led to more people in more places across the globe having the chance to pursue their dreams."

So what went wrong? Where did useful innovation morph into lunacy that almost brought down the whole system? The sea change began in 1969, Mr. Cohan says, when the first investment bank (Donaldson, Lufkin & Jenrette) sold equity to the public. Previously investment banks were partnerships whose capital came from the net worth of the individual partners, who would assume only the most modest risk since investment failure might endanger their life savings. But once a firm's capital could be increased by debt and equity financing—in essence, by other people's money—the calculus shifted.

Dodd-Frank and the Volcker Rule address the wrong problems and did nothing to fix Wall Street's broken compensation culture.

Ultimately all the big banks went public, and a risk-reward system that had encouraged prudence was replaced by a culture of swinging for the fences in the hopes of getting a big annual bonus. When Bear Stearns and Lehman Brothers went under in 2008, they were allegedly capitalized with more than 30 parts debt to one part equity.

What is the solution? Mr. Cohan concedes that some parts of the Obama-era regulations made sense. Excessive leverage had created perverse incentives: All the gain accrued to equity holders, while the losses were taken mainly by debt holders. Requiring banks to have more equity capital, as the regulations did, helped make the system more stable. But reinstating the Glass-Steagall Act—a move that was proposed in 2009 and remains on some legislators' agendas—makes no sense. The financial crisis, Mr. Cohan observes, "had nothing to do with the fact that there wasn't a wall separating commercial banking from investment banking."

Mr. Cohan argues that much of the regulatory content of the Dodd-Frank law, enacted in 2010, should be dismantled or "junked"—including the so-called Volcker Rule, which blocks commercial banks from engaging in proprietary trading. Dodd-Frank is indeed overreaching and overcomplicated. The law itself is 2,300 pages, and the rules implementing it take up some 22,000 more. "The job of nearly one out of every five people working on Wall Street these days," Mr. Cohan writes, "is to watch what the other four people do all day long."

He overstates the case, though, when he suggests that bank lending has been severely curtailed and that the "inevitable result" is to doom the economy "to a period of economic stagnation." In fact, bank credit has grown 23% over the past three years. Nevertheless, borrowing today is needlessly difficult. There is an aversion to even prudent risk-taking, with regulators breathing down lenders' necks.

Mr. Cohan's solution is to replace Wall Street's broken compensation system: the bonus culture that creates incentives to take big bets with other people's money while avoiding accountability when the bets go bad. He says that we need to "return to a compensation system that more closely resembles that of the partnership culture" of earlier times. Going well beyond calls for a claw-back of bonuses when trouble hits, Mr. Cohan proposes that the leaders of Wall Street firms be required to put their entire net worth on the line. Their co-op apartments, houses in the Hamptons, art collections and bank accounts would all be "fodder for the bank's creditors" if something goes wrong.

Bankers may find this idea even more repugnant than Dodd-Frank and the Volcker Rule. The trick is to produce some less burdensome combination of regulation and a new compensation structure that penalizes bad behavior but allows Wall Street to do what it does best: allocate capital from those who have it to those who need it.

Mr. Malkiel, chief investment officer of Wealthfront, is the author of "A Random Walk Down Wall Street."