BOOKSHELF BY BURTON G. MALKIEL

WILLIAM D. COHAN, *WHY WALL STREET MATTERS* (RANDOM HOUSE, 152 PAGES, $ 25)

In this slim volume, William Cohan, one of our most talented financial journalists, makes an impassioned defense of Wall Street banking institutions and argues that much of the financial regulation that followed the 2008 financial crisis was counterproductive. In his view the main culprit in exacerbating the financial meltdown was Wall Street's compensation culture, and he presents some controversial proposals to reform it.

Cohan notes the portrayal during the recent election campaign of the financial community as inherently corrupt. 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, Senators Bernie Sanders and Elizabeth Warren have lambasted Wall Street and decried the inclusion of so many Wall Street executives in the Trump administration.

Cohan reminds us that populist hostility toward the financial community has a long history. Alexander Hamilton's plan to have the Federal government guarantee payment of its debt at 100 cents on the dollar was a brilliant move that established the unquestioned credit of the United States. At the time, however, Hamilton was sharply criticized as rewarding evil speculators. "Bubbles" in asset prices and financial crises have been common in our history, and so has rage against the leading financiers of the time. Attempts were made to kill financiers such as Russell Sage, John D. Rockefeller, and J. P. Morgan. A truck loaded with dynamite exploded at the corner of Broad and Wall Streets during the 1920s, killing 20 people. Franklin D. Roosevelt savaged Wall Street in his first inaugural address.

It is in this context that Cohan explains the critical functions the financial community provides. The collective institutions that comprise "Wall Street" provide a "monumentally important and utterly irreplaceable service": "The ongoing ability of companies to get the capital they need from the people who have it and want to invest it is one of the most amazing contraptions that the world has ever constructed." Companies such as Apple, which sells its products all over the world, would not exist without Wall Street. While the behavior that caused the financial crisis must be stopped, Wall Street's essential elements "must be preserved, encouraged and praised." And while financial innovations played an important role in the recent financial crisis, financial intermediation must be preserved. Securitization of individual mortgages in liquid mortgage-backed securities provides more money for housing and lower mortgage rates. Securitization of auto loans makes financing easier for car buyers. The "junk bond" market allows businesses without perfect credit to obtain capital. "Financial innovation has allowed more people in more places across the globe to pursue their dreams."

What went wrong? Where did useful financial innovation morph into financial lunacy that almost brought down the whole financial system? How did mortgage-backed securities get sliced and diced into complicated tranches the legendary investor Warren Buffett labeled "financial weapons of mass destruction"? When did the principle of prudent risk-taking become the principle of "no risk is too great" as long as you assume it with other people's money?

The sea change began in 1969 when the first investment bank (Donaldson, Lufkin and Jenrette) sold equity to the public. Previously, investment banks were partnerships, whose capital came from the net worth of the individual partners. Only the most modest risk would be assumed since failures would endanger a partner's life savings. But once a firm's capital could be increased by debt and equity financing, the calculus was forever changed. The original partners needed to keep little of their own money in the firm, and banks could speculate with other people's money. Ultimately all the big banks went public and the risk-reward system that formerly encouraged prudence was replaced by a new culture of swinging for the fences in the hopes of getting a big annual bonus. When Bear Stearns and Lehman Brothers went under during the financial crisis, they were allegedly capitalized with over 30 parts debt to one part equity. When investment banks went public, the system went off the rails.

If we agree that Wall Street needs to be reformed so that is can better fulfill its critical functions, what is the solution? Cohan appreciates that some parts of the Obama-era financial regulations make sense. Excessive leverage created perverse incentives to accept very risky investments. All of the gain accrues to equity holders whereas any losses are taken mainly by debt holders (and possibly ultimately by the taxpayers).   Requiring banks to have more equity capital helps make the financial system more stable. But reinstating the Glass-Steagall Act, requiring the separation of investment and commercial banking, makes no sense: ". . . the causes of the 2008 financial crisis had nothing to do with the fact that there wasn't a wall separating commercial banking from investment banking."

Cohan argues that much of the regulatory content of the Dodd-Frank law enacted after the financial crisis is counterproductive and should be dismantled. Dodd-Frank is unconscionably overcomplicated, and it is needlessly difficult for qualified borrowers to obtain loans. The law itself is 2,300 pages long, and new rules implementing it take up some 22,000 additional pages. "The job of nearly one out of every five people working on Wall Street these days is to watch what the other four people do each day." Bank regulators can pass judgment even on individual loans.

Cohan overstates the case that bank lending has been severely curtailed and that the "inevitable result" is to doom our economy "to a period of economic stagnation." In fact, bank credit has grown 23 percent over the past three years. Nevertheless, borrowing today is needlessly difficult. There is aversion to even prudent risk-taking with bank regulators breathing down lenders' necks. Cohan concludes, "It's clear that Washington's desire to punish Wall Street" has gone too far.

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. We need to "return to a compensation system that more closely resembles that of the partnership culture" of earlier times. Going well beyond proposals for a claw back of bonuses when trouble hits, Cohan suggests that leaders of Wall Street firms should have their entire net worth on the line. Eliminate the current regulatory framework, but make bank executives understand that all the assets they have built up over the years will be at risk. Their co-op apartments, houses in the Hamptons, art collections, and bank accounts will all be "fodder for the bank's creditors" if something goes wrong. Many bankers may find this even more repugnant than Dodd-Frank and the Volcker Rule. The trick is to produce some less burdensome combination of regulation and compensation structure that penalizes bad behavior but allows Wall Street to continue to do what it does best: allocate capital from those who have it to those who need it more efficiently "than any other financial system on the planet."