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A Year Later, Little Change on Wall St.

By ALEX BERENSON

Wall Street lives on.

One year after the collapse of Lehman Brothers, the surprise is not how much has changed in the financial industry, but how little.

Backstopped by huge federal guarantees, the biggest banks have restructured only around the edges. Employment in the industry has fallen just 8 percent since last September. Only a handful of big hedge funds have closed. Pay is already returning to precrash levels, topped by the 30,000 employees of Goldman Sachs, who are on track to earn an average of $700,000 this year. Nor are major pay cuts likely, according to a report last week from J.P. Morgan Securities. Executives at most big banks have kept their jobs. Financial stocks have soared since their winter lows.

The Obama administration has proposed regulatory changes, but even their backers say they face a difficult road in Congress. For now, banks still sell and trade unregulated derivatives, despite their role in last fall's chaos. Radical changes like pay caps or restrictions on bank size face overwhelming resistance. Even minor changes, like requiring banks to disclose more about the derivatives they own, are far from certain.

Coming on the same weekend as the 11th-hour bailout of the giant insurer American International Group, and the sale of Merrill Lynch, Lehman's failure was the climax of a cataclysmic weekend in the financial industry. In the days that followed, nearly everyone seemed to agree that Wall Street was due for fundamental change. Its "heads I win, tails I'm bailed out" model could not continue. Its eight-figure paydays would end.

In fact, though, regulators and lawmakers have spent most of the last year trying to save the financial industry, rather than transform it. In the short run, their efforts have succeeded. Citigroup and other wounded banks

have avoided bankruptcy, and the economy has sidestepped a depression. But the same investors and economists who predicted, and in some cases profited from, the collapse last fall say the rescue has come at an extraordinary cost. They warn that if the industry's systemic risks are not addressed, they could cause an even bigger crisis — in years, not decades. Next time, they say, the credit of the United States government may be at risk.

Simon Johnson, a professor at the Sloan School of Management at the Massachusetts Institute of Technology and former chief economist of the International Monetary Fund, said that the seeds of another collapse had already sprouted. If major banks are allowed to keep making bets that are ultimately backed by taxpayer guarantees, they will return to the practices that led them to underwrite trillions of dollars in bad loans, Professor Johnson said.

"They will run up big risks, they will fail again, they will hit us for a big check," he predicted.

The doomsday view is far from universal.

Wall Street executives say the Lehman bankruptcy opened their eyes to the fragility of their institutions. They note that they have pulled back on risk and reduced leverage, creating a bigger cushion against losses. And they say that regulators were right to support the financial industry over the last year, rather than imposing new rules or allowing weak banks to collapse.

"There is less leverage in the entire financial system," said David A. Viniar, Goldman's chief financial officer. At Goldman, $1 in capital now supports about $14 in loans and investments, compared with $24 a year ago.

But even some senior Wall Street executives acknowledge the lack of change surprises them, given how poorly the industry performed last fall and the degree of government support necessary to keep it from collapsing.

"There was a general feeling that an enormous amount of additional regulation should be put in place to prevent what happened that weekend from happening again," said Byron Wien, vice chairman of Blackstone Advisory Services and the former chief investment strategist for Morgan Stanley and Pequot Capital. "So far, we haven't seen a lot of action."

Robert J. Shiller, the Yale University economics professor who predicted the dot-com crash and the housing bust, said the window for change may be closing. “People will accept change at a time of crisis, but we haven’t managed to do much, and maybe complacency is coming back,” Professor Shiller said. “We seem to be losing momentum.”

Kenneth C. Griffin, founder and chief executive of the Citadel Investment Group, a Chicago-based hedge fund that manages $13 billion, said that regulators and lawmakers needed to impose rules so failing banks could be shut, rather than allowed to operate indefinitely with taxpayer support.

“We’ve taken a lot of steps for the worse, and not for the better, in terms of the structural underpinnings of our capital markets,” Mr. Griffin said. “We have to change the rules and correct the fundamental flaws in the financial system.”

To be sure, Wall Street is not exactly as it was before the cataclysm of last year.

Then, a dozen or so big banks formed the top tier. Now Goldman Sachs and JPMorgan Chase are clearly the strongest, with Morgan Stanley struggling to compete. Bank of America and Citigroup are the weakest big banks, heavily reliant on government guarantees to survive.

“We have more separation between the healthiest and the least healthy of the big banks,” said Darrell Duffie, a finance professor at Stanford University.

Banks have collectively raised hundreds of billions in new capital to help cushion losses on bad loans and are taking a more prudent approach to lending and underwriting. The worst excesses of 2006 and 2007, when banks lent hundreds of billions of dollars against all kinds of real estate at terms that even at the time seemed absurd, have ended.

But those changes are not unexpected. Banks typically raise lending standards during recessions. And even if they wanted to keep up underwriting, they would not find much of a market. Many pension and hedge funds have suffered huge losses on mortgage-backed bonds and are hardly rushing to buy more.

Critics of the industry argue that the pullback in risk will be only temporary without deep regulatory changes.

Nassim Nicholas Taleb, a statistician, trader, and author, has argued for years that financial firms chronically underestimate their risks and must be managed much more cautiously. Universa Investments, a $5 billion fund in which he is a principal, made more than 100 percent profit last year betting on the possibility of a collapse.

Mr. Taleb warns that the system has grown riskier since last fall. The extensive government support that began after Lehman collapsed will lead investors to assume that governments will always prevent major banks from collapsing, he said.

So investors will lend money to the financial industry on easy terms. In turn, financial institutions will use that cheap money to make risky loans and trades. The banks will keep the profits when their bets pay off, while taxpayers will swallow the losses when the bets go bad and threaten the system.

Economists call the phenomenon moral hazard. Bankers have a different term: I.B.G. The phrase implies that by the time a deal goes sour, “I’ll be gone,” after having received a sizable bonus.

Despite the predictions last year about pay cuts, those bonuses appear secure. Kian Abouhossein, an analyst at J.P. Morgan in London, predicted this week that eight major American and European banks would pay the 141,000 employees in their investment banking units $77 billion in 2011 — about $543,000 per worker, not far from the 2007 peak — even after minor regulatory changes are adopted.

Because the rewards are so rich, the banks will not change unless regulators and lawmakers force them, Mr. Taleb said.

“I don’t know anyone on Wall Street who goes to work every day thinking of anything but how to increase their bonus,” he said.

To prevent a replay of last year’s crisis, investors in financial institutions, especially bondholders, must believe that they will lose money if banks fail, said Sheila C. Bair, the chairwoman of the Federal Deposit Insurance Corporation. “You need to send that very strong, clear signal to restore market discipline,” Ms. Bair said.

But legislation that would allow regulators to close giant institutions in an orderly fashion has been stalled for

months. So too have efforts to create a systemic regulator that would focus on the broader risk that might occur from the ripple effects caused by the failure of one major bank.

Another proposed change would require banks to list and trade derivatives through a central clearinghouse, just as stocks and options are traded through exchanges, but it has yet to go anywhere.

The term derivatives encompasses a variety of financial products, including contracts whose value changes as interest rates move and insurance that pays off if a bond defaults. Derivatives drove the boom before 2008 by encouraging banks to make loans without adequate reserves. They also worsened the panic last fall because they inherently tie institutions together. Investors worried that the collapse of one bank would lead to big losses at others.

Requiring that derivatives be traded openly sounds like a relatively small change, but it could have important effects.

Exchange trading would open pricing for derivatives, so banks could not hide money-losing positions. Banks would have to put up money as positions moved against them, since the exchanges would seize and sell derivatives that were not backed by adequate margin. That move would help avoid the situation A.I.G. faced last year, after it wrote hundreds of billions of dollars of credit insurance and had no money to make good on its promises when the bonds defaulted. But critics say that even the proposed changes would not go far enough, because they would exempt some complex derivatives from exchange trading or clearing. Moreover, some banks oppose opening derivatives trading, because it would cut their profits by making pricing more visible and as a consequence competitive. For now, legislation to force derivatives trading onto exchanges has stalled, and banks are still writing contracts with limited regulatory oversight.

“The off-exchange derivatives market is still the Wild West,” Ms. Bair said.

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