Crisis In and Out of the Financial Markets

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This is STANY week, when the members of the largest affiliate of the Security Traders Association gathers together to celebrate the work of New York area equity traders, which these days include quite a few options traders. This is also a time of great crisis in the financial markets.

Ironically, the equity markets are up today. On the whole, the equity markets have been buffeted about, but have not collapsed, which makes this crisis different than those that began in 2000 or 1987 or, for that matter, 1929. In those crises, the equity markets fell dramatically, and in the case of the 1929 crisis, kept falling for four long years. That hasn't happened to this equity market. Not yet. In fact, while there is little in recent years to cheer the hearts of equity traders, profits on the desk are up a bit. Volatility encourages more trading.

Make no mistake about it. This is a crisis in the financial markets and it is very real. The unprecedented federal takeover of Bear Stearns suggests that the magnitude of this crisis is greater than has been observed in many, many years. The difference is that the crisis affects the debt markets and its exotic derivatives. The auction-rate preferred market is in trouble, the market for credit default swaps is rumbling the earth, and the interbank credit market is in disarray. Meanwhile, the equity markets haven't quite determined what to make of all of this. So, they are up one day and down the next, boosting profits on equity trading desks.

For a prior example of this sort of crisis, one would have to look back to the back office crisis of 1968. That famous crisis was caused, oddly enough, by a bull market.

In 1968, all transactions in securities were settled in paper. Clearing and settlement generally was a four-step process. First, the beneficial owner would deliver a stock certificate together with stock powers to a broker. Second, the broker would then deliver (generally by a runner) the stock certificate to the broker used by the purchaser. Third, the purchasing broker would deliver the certificate to the purchaser who, for the fourth step, would submit the certificate, along with attached stock powers, to the transfer agent for registration. This process involved multiple re-registrations on the books of transfer agents. Despite inflation, clearing and settlement was much more expensive in 1968 than it is today.

In the fall of 1968, this system for clearing and settling securities transactions disintegrated into chaos. Volumes in the equity markets exploded. The back office was overwhelmed by the increased volumes and began to fall behind. Processing delays at one firm held up the work at other firms who were waiting to receive stock certificates. Errors were generated causing more work; certificates were lost or stolen. By December 1968, unsettled trades had accumulated to $4 billion and the trade settlement system had broken down. This "paperwork crisis," which lasted until 1971, was described in the resulting Congressional hearings as "the most prolonged and severe crisis in the securities industry in 40 years."

It is hard to imagine members of Congress sitting through hearings describing back office processes. But, these were extraordinary times. To catch up, brokerage firms worked in shifts around the clock and on weekends. This proved insufficient. So, on Wednesdays, for three long years, the markets closed. All of this in a bull market. This catastrophe got the attention of legislators.

As usually happens in a crisis, shotgun marriages were arranged, folding the firms that were the most disrupted into their more organized competitors. The New York Clearing Corporation, which was ultimately succeeded by The Depositary Trust Company (DTC), was established as a securities depositary. Firms were "strongly encouraged" (ie., arms were broken, where necessary) to deposit securities in DTC, which facilitated clearing by book-entry transfers.

Today, transactions using paper certificates are so unusual that market participants often have to call their lawyers to consummate the transaction. Book-entry transfers are far and away the normal way to clear and settle transactions in securities.

The market effects of the transformation to book-entry have been astounding. Book-entry transfer has reduced clearing costs to a tiny fraction of their 1960's equivalent. The system can handle enormous volumes with almost no errors.

On the other hand, reduced clearing costs have made it possible for millions of retirees to day trade their retirement income, of less obvious benefit to society. And, the runner has been abolished, an occupation that launched many a famous career on Wall Street.

The back office transformation spawned out of the 1968 crisis also has implications for "mutual recognition." Clearing and settlement costs in the United States are roughly 100 times less than in Europe, which has grudgingly moved to book-entry, but still retains some aspects of the old certificated clearing and settlement system. This fact of life is the 800 pound gorilla in the room for international regulators who seek to establish a unified system of securities regulation.

My guess is that European regulators, in their zeal to establish a coordinated system of securities regulation with the United States, ultimately will take the same actions as US regulators in 1968 - 1971. A unified system of European clearing and settlement will be established with DTC, firms will be forced to subscribe and European clearing costs will collapse. This will result in reduced profitability for

European clearing firms and the loss of back office jobs. True mutual recognition and expanded markets will surf to victory on a wave of back office evolution.