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Resilience of the US securities industry to the global financial crisis

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ABSTRACT

The global financial crisis was underpinned by the securitization of subprime mortgages led by US investment banks, and its outbreak was marked by the bankruptcy of Lehman Brothers on 15 September 2008. This paper investigates the resilience of the US securities industry to this shock and its evolution between 2008 and 2016, with focus on employment, location, remuneration, sell-side versus buy-side dynamics, and gender. Results show that the US securities industry has suffered significant losses in terms of employment and its recovery has been slow. Under the pressures of depressed demand, new regulation and cost cutting, the industry has gone through significant adaptation in terms of corporate reorganisation, value chain optimisation, market reorientation and innovation, but has not yet adapted in terms of remuneration. The buy-side of the industry has performed much better than the sell-side in terms of resistance and recovery. The patterns of resistance and recovery have been highly uneven across states and cities. While the top of the hierarchy of securities industry centres has not changed significantly in terms of ranking, large centres, with New York in the lead, have suffered larger job losses than smaller centres, reflecting a significant spatial dispersion of employment in the industry. Male employment has proven more resilient than female employment highlighting continued gender inequality and lack of diversity.

1. Introduction

Investment banks have been at the epicenter of the subprime crisis in the USA, and its transmission to Europe and the rest of the world, which led to what is referred to as the global financial crisis (GFC) or the great recession (Sorkin, 2010; Tett, 2009). They are the key players in the securities industry involved in the production and circulation of financial securities and derivatives. Albeit with significant interruptions, the securities industry had boomed between the late 1970s and 2008 in the US, and this boom has spread to the rest of the world, accompanied by the growth of capital markets, cross-border capital flows, securitization of different forms of credit (from mortgages to car and student loans) and the invention of new types of securities and financial derivatives. Over thirty years ago Susan Strange described investment banks as croupiers in casino capitalism (1986). Recently, the economic, political, social and cultural power of investment banks in the world, and particularly the US, has been captured in the term 'investment bank capitalism' (Wójcik, 2012). This term drew attention to investment banks as keystone species of contemporary capitalism, waging extraordinary influence not only in the world of financial markets, corporations and governments, but also in shaping the very way we perceive and measure the world economy. When we consider concepts such as emerging markets, frontier markets, BRICs, or value at risk, all of those owe their popularity, if not conception, to investment banks.

Investment banks, hedge funds and other securities firms feature as main characters (mostly culprits) in many books on the roots of the GFC and the ongoing reform of the international financial system (Lewis, 2010; Sorkin, 2010; Tett, 2009), but to the best of our knowledge there are no systematic accounts of how the industry as a whole has changed since the crisis. Surely, if we recognise the position of securities industry at the fulcrum of a system that failed, we need to investigate whether it has changed sufficiently to give us hope that the system will operate better in the future. With the tenth anniversary of Lehman Brothers' collapse fast approaching as we write, the time is ripe for such an analysis. Geography is particularly well-suited to the task, as it allows us to consider a wide range of economic, political, social, cultural and technological factors, which all potentially shape the post-crisis transformation of the securities industry or lack thereof.

In this context, the goal of the paper is to investigate the resilience of the US securities industry to the GFC and its evolution between 2008 and 2016. The US is not only the source of the GFC but also the cradle of the modern securities industry and by far its biggest market (Morrison and Wilhelm, 2007). The GFC has fueled interest in resilience in social and economic sciences, including geography. In the latter, focus on regional resilience has recently been complemented with studies on

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sectoral resilience. Geographical research applying a resilience perspective to finance, however, has been extremely rare, with no studies focusing on the securities industry, despite the fact that this was the industry at the very epicenter of the GFC. An additional reason making such an application important is the position of the securities industry as the elite of the financial and business services complex (Wójcik, 2018). Financial and business services as a whole have become central to urban and regional economies not only in terms of their size but also their overall resilience. They are considered to be innovative and adaptable, with high capacity to assimilate, exploit and transform new ideas and diffuse them across their regions (Storper and Scott, 2009). They attract highly-skilled human capital that contributes to regional entrepreneurialism and offer high salaries that imply large local multiplier effects. Finally, they affect the availability of capital in cities and regions (Wójcik, 2011). As such, asking whether and how the securities industry, particularly in the US, has resisted and adapted to the GFC has relevance for understanding the future of capitalism as well as regional and urban development trajectories.

The paper will proceed as follows. In the next section, we will develop a conceptual framework for the paper, by reviewing geographical literature on resilience and applying it to the securities industry. The following four sections will explore the resilience of the US securities industry to the GFC, starting with broad patterns of resistance and recovery (Section 3), delving into sub-sectoral patterns (Section 4), analysis across regions and cities (Section 5), and finishing with resilience in relation to gender. The concluding section will elaborate on what the results tell us about the nature of change in the US securities industry, its future trajectory, and further research needed on this topic.

2. The conceptual framework: sectoral resilience and the securities industry

Resilience can be defined as "the ability of a system to undergo anticipatory or reactionary reorganization of form and/or function so as to minimize the impact of a destabilizing shock" (Martin, 2012, 5). The geographical literature distinguishes between three basic types of resilience. Engineering resilience involves the ability of a region to return to a pre-shock growth trend (or business as usual). Ecological resilience means that a shock throws a region past a threshold, beyond which a return to the pre-crisis growth path is impossible. Instead the region embarks on a new development path, which may involve slower or faster growth. Finally, adaptive resilience, which derives from the theory of complex adaptive systems, stresses the ability of a system to reconfigure and adapt its structure so as to maintain an acceptable level of activity and growth (Boschma, 2015; Boschma and Frenken, 2006).

Studies on resilience also distinguish between two major dimensions of the process. The first is resistance understood as vulnerability or sensitivity to disturbances and disruptions. The second is recovery from a shock, including the renewal of a growth path and the possibility of structural re-orientation, also referred to as re-alignment or adaptation. In this paper we are interested in both resistance and recovery and engage with the concept of adaptive resilience. We consider the GFC as a major existential crisis of the US securities industry, which opens a possibility, if not necessity, for structural re-orientation and adaptation.

The study of resilience begs a four-part question: resilience of what, to what, by what means, and with what outcome? Of what concerns delimiting the system in question, how resilience is measured, and criteria used to determine if the system has changed its structure or function as a result of a shock. The system in question in our paper is the US securities industry. The primary function of the industry is the production and circulation of securities, which help companies and governments raise capital and match both, as issuers of securities, with institutional and individual investors. This intermediary function leads to an important distinction between the sell-side and buy-side of the industry. Sell-side, with investment banks in the lead, works primarily with issuers of securities; buy-side, with asset managers in the lead, serves mainly investors. Sell-side is more wholesale-oriented, high-value, low-volume business, focused on big deals for big customers. Buy-side is more retail-oriented, low-value, high-volume business, focused on process, and a more bureaucratic, low-profile activity. Throughout the paper we recognize the nature of the US securities industry as an open system. US securities firms have international presence and foreign firms have presence in the US. Capital, services, labour and other markets in which securities firms operate are highly integrated internationally, if not globally (Wójcik, 2011).

While employment is the critical variable for studying regional resilience, for an industry it would be ideal to use both employment and output. To measure resilience we use employment data, complemented, where possible, with data on revenues and profits. Unfortunately output data is limited and available only for the whole country or for individual firms, often operating internationally. The US Census offers quarterly data on employment in the securities industry, its location, payroll, and gender structure. This data allows us to investigate not only the overall size but also the structure of the industry along three dimensions: sell- and buy-side as its key subsectors, spatial distribution of employment including securities industry centres, and gender. Payroll data offers us a chance to go beyond raw employment figures and delve deeper into structural responses to the crisis. Focusing on employment, its location and payroll, we focus on resilience for employees of securities firms and places of employment rather than on resilience for the shareholders/owners of the industry. We take the 'whose resilience' question seriously by extending our analysis to gender. While many existing studies consider diversity as an input, a factor that in most cases affects resilience positively (Martin and Sunley, 2015), we also consider it as an output, affected by the process of resilience.

The shock in question is the GFC, which erupted in full in the US in September 2008 with recession lasting until late 2009. There is little doubt that the GFC has had a major impact on the US securities industry, mainly through depressed demand for their services and new regulation. Since 2008 returns on securities and financial markets in general have been at historically low levels. One major reason is a slowdown in the global economy, combined with high uncertainty. Another reason is the unprecedented level of government and central bank intervention in financial markets, with headline interest rates close to zero, and in some countries, even below zero. Economists refer to this situation as financial repression, whereby governments keep interest rates below inflation rate, thus transferring wealth from savers/lenders to borrowers. Alongside savers, the financial sector becomes repressed in the process as well.

The GFC has unleashed a wave of new regulation. This was led by the 850-page long Dodd-Frank Wall Street Reform and Consumer Protection Act in the US, signed into law in 2010. The body of new regulations based on Dodd-Frank Act has now exceeded 10,000 pages and has been supplemented with numerous international regulations led by the Financial Stability Board, housed by the Bank for International Settlements in Basel. Regulatory changes focus on higher capital requirements, restrictions on proprietary trading (in contrast to trading on clients' accounts) called Volcker rule, stricter disclosure requirements, more responsibility for internal risk management, and restrictions on securitization of loans. These have been accompanied by regular stress tests of banks conducted by the Federal Reserve Bank, to simulate how they would perform under crisis conditions, and numerous lawsuits conducted by federal agencies, against investment banks in particular, related to mis-selling of securities, market manipulation, and other misdeeds. US investment banks have paid over $100bn in fines since 2008 (The Economist, 2016). To be sure, the securities industry, as key players in the financial sector lobby, has worked hard to influence the reforms, both in the US and internationally, and in many respects the reforms to date should be considered inadequate (Bayoumi, 2017; Helleiner, 2014).

The question of resilience by what means concerns mechanisms and

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