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## BUSINESS OUTLOOK – RESTRUCTURING THE BANKING SYSTEM

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It is clear that the U.S. system of banking institutions needs to be restructured as it is essentially impossible to manage and regulate in its current form. We have a novel suggestion for such restructuring – how about trying the old system? In particular, we think that the government should seriously consider a new system which would reestablish the spirit of Glass-Steagall regulation.

Background: The Glass-Steagall Act was adopted following the financial Crash of 1929 to separate the speculative investment banking business from the depository commercial banks which housed them. Post the introduction of Glass-Steagall, the U.S. had essentially a 3-tier system of regulated banking institutions: thrifts (savings banks, savings and loans, credit unions, etc.), commercial banks (corporate lenders and, increasingly, consumer lenders), and investment banks (stock brokerage, investment advisory and corporate advisory firms). The system worked well for nearly 70 years in terms of separating the depository institutions from potentially excessive capital markets risk, and essentially limiting such risk assumption to the investment banking sector.

Led by CitiBank, the “financial supermarket” concept captured the imaginations of investors and, with government approval, Glass-Steagall capitulated in 1999, and major banks became involved in insurance, the underwriting of equity securities, money management, private equity, etc. A new age of commercial banks and investment banks being reunited, under common ownership, was born, and the last decade has been an unmitigated disaster for both.

So What ...? We believe that the previous financial regulatory structure permitted the existence of specialized consumer depository savings institutions dedicated to originating, and retaining, mortgages for U.S. homeowners in a well regulated, stable atmosphere (see [Postscript](#)). Similarly, commercial lending by commercial banks was a relatively well regulated, if not exciting, business. Capital market risk and innovation was the purview of investment banks and was subject to both regulatory oversight and objective limitations on risk imposed by the commercial banks which made broker/dealer loans to the investment banking community. (Commercial banks are now potentially conflicted in such objective Wall Street lending policies, as they may now also be direct participants in the investment banking business).

We are concerned that forced merging of troubled commercial and investment banks is an expedient measure, rather than a long-term solution for restructuring our financial institutions. All of the previously discussed depository financial institutions (savings banks/thrifts, commercial banks,

investment banks) are now increasingly jumbled up into one structure which, for lack of a better term, we will call “quasi-bank”. Merging more of them together serves only to potentially compound a bad business model, which is the genesis of our current financial crisis.

It is our opinion that the aforementioned three distinct types of banking institutions, with clear, efficient mission statements and specific dedicated regulators, better serves our financial economy than does the frequently suggested quasi-bank structure, under one regulator. Combining all of the aforesaid financial functions into quasi-bank means that a regulator will have to derive a weighted risk asset standard that will suit all quasi-banks. We do not believe that this is an easily regulable model and would tax the regulator’s ability to continually monitor shifts in varying risk assets across such a broad spectrum of possible loan and capital markets assets categories. Instead, we favor differentiated base capital structures for thrifts, commercial banks and investment banks predicated upon their different charter authorizations and risk profiles. Variations for capital structures of individual institutions within the foregoing categories could then be regulated and fine tuned on a risk-asset basis by the responsible regulator.

The Need for Differentiation: Moreover, we believe that depository institutions should minimize risk, both to maintain the confidence of the populace, and to be able to effectively perform their functions of responsibly expanding the economy through the multiplier effect of their lending activities. There is no reason why depository institutions should be considered to be growth-stock candidates, as opposed to financial utilities. If the revenues and earnings of depository institutions, systemically, significantly outpace the growth of the real economies which they serve, such is a result of greater risk assumption, either in terms of market risk, credit risk, or leverage risk. On the other hand, we also believe that those investment banks whose basic business is the capital markets, should be able to be more risk assumptive than depository institutions, as long as their non-depository equity capital sources understand, and are fully qualified, to accept such risk.

Essentially, it is our opinion that the best way to regulate banking institutions is to clearly define, and limit, their areas of business operations, rather than having every quasi-bank potentially involved in all possible financial markets areas. A defined business charter is the best friend which a dedicated regulator can have. Having said so, we acknowledge that a consolidation and/or reduction in the number of existing, and occasionally conflicting, commercial banking regulators, per se, (the Fed, Comptroller of the Currency, state banking commissions, etc.) would be a good idea.

Oil and Water: Finally, there is the demonstrated reality that risk-averse organizations, such as commercial banks, cannot manage risk-assumptive organizations, such as investment banks, without making them sub-par performers, or destroying them entirely (and, we expect, vice versa). Various non-bank corporations (General Electric Sears), insurance companies (Prudential, CIGNA), and commercial banks (Citi, Deutsche Bank) have tried and failed.

It is not a question of intelligence or judgment; it is just that risk-averse organizations, and the people who populate them, are innately psychologically different from risk-assumptive investment banks and their staffs. In such a match-up, the commercial bankers always ultimately win, since the predominant commercial bank regulators are also risk averse, and rightly so.

Historically, and from personal experience, joining together commercial banks and investment banks has led to underachievement and instability for both entities. The “supermarket bank” concept is the Yugoslavia of the financial world.

Summary: What do we say to those who suggest that “you can never go back” to earlier regulatory models and “the horse is out of the barn”? We weren’t there, but we expect that similar arguments were likely advanced in the early 1930’s that existing commercial banking and investment banking activities could never be split from common ownership.

Restructuring of the banking institutions sector needs an **endgame**, otherwise we are simply uniting the current biggest losers at the dance. Instead of creating a whole new financial structure, why not reinstitute the system which worked well in the past?

Postscript: The area of depository thrift institutions deserves greater attention than we can dedicate to the subject. Suffice to say that thrifts, as primarily originators and holders of fixed-rate consumer mortgages, were essentially eliminated by the revocation of interest rate ceilings on savings deposits under Regulation Q, and the advent of higher yielding money market funds rates for individuals, in the early 1980’s.

A thrift intermediary needs a stable source of low-rate funding in order to be able to provide longer-term, fixed-rate mortgages for consumers. Perhaps advantageous tax policies to reduce taxation on interest earned on thrifts’ deposits might be one answer. In any case, we think that public and private pension funds will be less enthusiastic in the future about providing the majority of such fixed-rate funding through securitized mortgage purchases, particularly if, and when, serious inflationary considerations reappear in the economy.