

Observations on Banking Regulation

January 23, 2010

Bring Back Boring Banking!

\$550B invested in banks has returned a handsome profit. Now comes the hard part: regulatory change to restore confidence. The US cannot do it alone, and our political mess may mean we cannot effectively do it at all.

- Boring banking is regional. Lending and paying – for a family, fund, company or government – requires a local face. Intimacy *requires* contact.
- Investment banking is global. Raising capital for companies (or advising them in deals) and proprietary trading are new age businesses: it hardly matters the zip code of the ideas, money or clout. Great riches and great skill travel very well!
- Fiduciary banking (serving client interest first and only) is both global and local. Acting for funds has always been a fiduciary activity, but selling stocks to a family is in a gray area: the tone is fiduciary, but the pay is pure predation.

It is high time we brought the boring back into banking, worldwide.

First, a history quiz: why was Glass-Steagall repealed? No, not so bankers could get rich by becoming brokers. The “universal bank” – combining all three forms of banking – is the norm outside the US. As the world economy globalized in the 80’s, the easiest products to export were money and advice. EU, UK and Japanese banks sold to US clients, buying deals with bucks and global reach.

We also lost offshore opportunities to full-function universal banks, just because a 1933 law said we could not team up. “Set our banks free to compete” cried the lobbyists, “level the global playing field.”

Now we see that universal banks can be “too big to fail” because of systemic risks. We now realize they are pro-cyclical *by design*. (You know the cycle: assets marked to market, falling share price begets risk, recycled as still lower asset values.)

A U.S. fix that is not the same as the global fix will be useless at the global level and just plain stupid for the US.

There will *never* be a global fix that follows Glass-Steagall. The reasons are parochial, anti-competitive and pragmatic, yet very powerful. So what *could* be done?

Global banking regulators might segregate the activities of banks into distinct and separately capitalized subsidiaries, each of which conducts one of the three businesses. Each subsidiary would submit to a distinct regulator suited to the businesses conducted in the subsidiary, and the parent would be regulated by its listing market:

- The parent company would be a financial holding company with a capital structure as required to finance equity investment in its subsidiaries, with capital in reserve for crisis or acquisition but prohibited from any guarantee or loan to a sub. *Only cash equity investment, with only dividends from earnings flowing uphill.* This lets big banks have big market cap with common brand and leadership while closing the capital slush fund.
- Each subsidiary would augment parent equity with mezzanine and debt from unaffiliated sources, bankruptcy remote from affiliates and the parent (as AIG insurance subs remain viable). No single subsidiary would ever be too big to fail.

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- Boring banking is regional, so it would be regulated locally/regionally. Each subsidiary would be reported by the parent as if it were a public company in both local and parent jurisdiction. Yes this is expensive and a pain in the ass, but necessary to inspire confidence.
- Investment banking is global, and can be regulated by coordinated securities regulators. Prop trading is in this subsidiary. Regulators of securities firms and markets (FSA, SEC, etc.) are well along in applying essential regulation of client protection, capital and risk. The subsidiary would separately be reported under both US GAAP and IFRS.
- Fiduciary banking needs to be separated from its affiliates. Custodians, portfolio managers and retail “advisors” (we used to call them brokers) need to be held to a *worldwide fiduciary standard*. Private bankers, brokers, trustees and portfolio managers must be held to the same standards. From private equity to hedge funds, the goal is to enrich the client. *Fiduciary business should never coexist with boring or investment banking.*
- **Good fences make good neighbors:** the management of the parent company must assure that affiliates do not cross-deal by paying the employees of another affiliate, false flagging the services of another, or using influence. Realistic? Yes; and the audit process will enforce the separation of subsidiaries.

This is a workable solution, so it is anti-populist. President Obama needs to decide what he wants: real results or wild applause. In this regard, he is trapped in a transition from *campaigner* to *statesman*.

Populist rhetoric is the opiate of politicians, and leads them astray every time. If politics is the art of the possible, we need a new

regime within which regulators with relevant skills take on jobs that real people can fulfill. The idea of a regulator that “controls” risks that threaten the system is goofy: the unexpected will always be, yes, *unexpected*.

They say Main Street just wants a show, a public flogging or branding of the bankers. Instead, our administration might strive to give us and our children a workable regime wherein large companies can compete without concentration of unrecorded risk.

It will be hard to get the UK, EU and Japan to adopt a US regulatory regime, but this is a task for which Obama is suited. Indeed, it has been decades since the tone, process and popularity of an American president was able to lead instead of bully the world.

Nothing less than a global solution will suffice. If the US restores Glass-Steagall it will cut US banks into smaller companies which be less competitive at home and abroad, where much of the future growth resides.

It will be hard to calm the populist rage of our middle class – it will take extraordinary charisma and passion. Again, we have the right man for the job, as evidenced by his speeches on race and war. Obama’s ear for the music and the magic of sincerity is just what is needed properly to fix our purpose and yet acknowledge our pain.

To pillory bankers is to visit upon the sons the sins of elders. We will reap a whirlwind of unwelcome consequences if we give in to ephemeral satisfactions of populist rage.

If the multi-regulated holding company succeeds, the US middle class will win. They will enjoy growth and access to capital as in yester-decade, with essential protections. Additionally, our banks will be competitive in the rapidly growing global market as well as in our “New Normal” domestic economy.