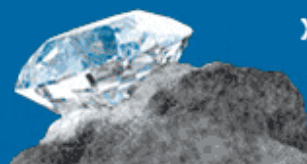


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# FINANCIAL NEWS

## Investors await the ‘new normal’

Roy C Smith

07 Dec 2009

**The past year has been anything but normal for the world’s largest banks. Several have been nationalised or otherwise turned into over-directed captives of their regulators. Others, however, have benefited handsomely from the windfall of numerous government efforts to stabilise the banks and stimulate growth.**



Roy C Smith

Restrictions on balance sheets promised by regulators have yet to be imposed, giving banks a free ride in a well-supported market. Talk of breaking up banks or of restricting risky activities hasn’t turned into action, and seems to lack consensus.

The US [Congress](#) is discussing new financial legislation, but is more interested in who the systemic regulator should be than what it should do. For many banks, the past several months have been easy-going and the threat of drastic regulatory change seems to have receded.

But this may just be the eye of the storm. Large banks are bracing themselves for heavy weather in their consumer lending and commercial real estate areas. Though bank stock prices have recovered, they are well below historical highs or even average price-to-book value ratios.

Whatever the rearrangement of the regulatory furniture, the new normal is going to have to include some basic changes. There is a push-back on banks to accept the fact that they are expected to operate as benign public utilities, not as aggressive entities only interested in shareholder gain.

Regulators will find a way to drive this home – by tightening capital requirements, increasing deposit

insurance costs, and by restricting incentive compensation programmes. While governments may appear to be dithering, the Basel Committee is hard at work on tougher new capital, leverage, liquidity and counter-cyclical standards to be identified later this year and introduced during 2010.

Large, high-visibility banks will also come under continued public scrutiny, especially regarding compensation, which will complicate business activities. Those riskier sections of the banking business, such as proprietary trading, hedge fund management and private equity, may no longer be competitive under the umbrella of a too-big-to-fail banking holding company. The Basel group has agreed to retain trading book rules adopted in July even after learning they require two to three times as much capital as the old rules. People and assets may migrate to escape the attention and the restrictions. Thus, the banks have an incentive to rethink their mix of businesses to try to strike the right balance between their trading and service activities.

From their shareholders' point of view, this exercise may be years overdue. Large banks have traded for some time at price-earnings and price-to-book ratios below those of other businesses. Investors have found these stocks to be more volatile and unpredictable than comparable standout companies in retail finance, insurance and asset management.

The combination of non-transparent trading exposures and the questionable ability of managers to control these trillion-dollar colossi have resulted in investor downgrading of even the topmost market leaders. Maybe it is time for the banks to take the initiative in breaking themselves up (rather than wait for regulators to do it) into more investor friendly units.

This means, as former [Federal Reserve](#) chairman [Paul Volcker](#) has suggested, spinning off the risky trading businesses and preserving the basic bank as a high grade service provider. It could do the banking, underwriting and asset management together with client-driven positioning, market-making, prime brokerage and custodial businesses, much as it does now, but free of loss exposures from proprietary trading and investing, hedge funds, commodities and private equity. These businesses and proprietary investments in mortgage-backed securities and real estate are what sunk [Bear Stearns](#), [Lehman Brothers](#), [Merrill Lynch](#), [UBS](#) and [Citicorp](#).

They could be sold or spun off as a [Blackstone](#) lookalike to risk-seeking investors not wanting to be bogged down in the traditional banking business. Capital and borrowings associated with these businesses could be transferred out from under the regulatory umbrella with all the attendant capital requirements, public disclosures and attention. Most of the highest paid employees – the traders and strategists – would go with the assets they command. It is quite likely that such an exercise would result in the market value of the sum of the parts of the bank being greater than that of the company before it was broken up.

The new normal in banking could mean a return to common sense: the banks would be smaller, leverage would be reduced, there would be no need for off balance sheet asset parking, managerial tasks would be simplified, the payroll reduced, conflicts of interest diminished and the pace of daily life moderated.

All this would be done according to a voluntary plan to maximise shareholder value. The banks would have their large market shares, global reach, prestige and expertise to rely on, and could ease investor expectations with generous dividends or stock repurchase programmes. The sold-off trading businesses would benefit greatly from being replanted outside the too-big-to-fail circle where they could attract financing from pension funds and other institutional investors and wealthy families, without being worried about limits on intrusive capital controls or limits on compensation.

The banks have a limited history of being willing to give up anything accumulated over the years.

Many believe they have to have large, wide-open trading platforms to see “all the market flows” in

order to best serve clients and to position themselves against market reversals. The past few years have not shown this to be the case for many firms. Sooner or later, in the highly competitive, deregulated environment that the large banks have been in, even skilful traders such as Bear Stearns, Lehman or Merrill Lynch meet the unexpected risk big enough to bring them down. They, the regulators and the taxpayers will be better off trying to find the new normal.

- Roy C Smith is professor of international business at [NYU Stern](#) School of Business

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