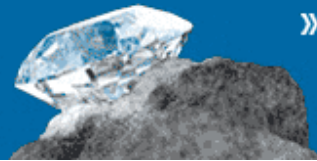


Dow Jones Investment Banker™
THE BIG DEAL IN INVESTMENT BANKING



» MAKE
BIGGER
DEALS
NOW!

FINANCIAL NEWS



Reshuffling the banking pack

Roy C Smith

14 Dec 2010

As hated as they are, bailouts, until recently, were accepted as a necessary evil: a safety net to preserve the financial system after regulatory measures fail. They usually work to stop panics and are much cheaper than letting everything go up in smoke.



(Source: Asimzb)

The [Federal Reserve](#) has admitted that it alone deployed \$3.3 trillion to stabilise massively disrupted credit markets after the bankruptcy of the unbailed-out Lehman Bros.

But the banks are now being told the era of too-big-to-fail is over. The [Dodd-Frank Act](#) has forbidden bailouts and will subject systemically important banks to “enhanced” regulation to prevent failure. Governments have also loaded banks with new taxes, fees and other expenses to recover taxpayer losses. Together with higher capital requirements from [Basel III](#) and regulations yet to be finalised, the composite package hopes to suppress big banks’ appetites for risk.

Having removed the safety net, however, what the government still needs is a fail-safe financial system. So far they haven’t achieved this. To be fail-safe, a system must prevent dangerous levels of risk from becoming highly concentrated. It must be willing and able to transfer the risk of systemic collapse to the less regulated broader market, where losses can be sustained without inducing runs

on other institutions.

Indeed, a great deal of market risk in collateralised mortgage obligations, leveraged loans and derivatives was distributed from 2003 to 2007 to smaller banks, insurance companies, hedge funds and other institutional investors (the so-called “shadow banking system”) through securitisation and other instruments.

The problem in 2007 was that too many big financial firms chose to cling on to these risky assets rather than distribute them. Some of the smaller non-banking firms failed, but they did not precipitate the systemic crisis. What did so was the extreme concentration of mortgage-related securities held by large financial firms in long-term trading positions.

So far, policymakers agree only that to be fail-safe, banks must have risk-adjusted capital sufficient to cover almost anything. They have not required that banks be broken up or required them to give up securities transactions or be de-risked in important ways.

Some banks believe they can endure higher capital and operating costs, much of which can be passed on to customers, without having to change their present business models very much. Others, however, wonder whether the reduction in their profitability and the increase in their capital costs might make their businesses uneconomic and therefore invite strategic changes.

The extent to which strategic change actually happens will depend on how transformational the new regulatory regime is seen to be. The big question is whether big banks will give up the large “flow-based” global trading platforms they believe are essential to maintaining their market shares and profitability.

After the last crisis, between 1984 and 1994, many large US banks were subject to harsh discipline by a tough-love Federal Reserve. They were prevented for as long as 10 years from growing at much more than the inflation rate, while bad assets were written off. They were forced to give up all but the most basic banking businesses, while selling their headquarters and other assets to reduce their leverage.

Except for mergers of the weak into the strong (of which there were many), large banks were prevented from growing through acquisitions.

Regulators also sued officers and directors of failed financial institutions – 1,850 bank officials were sued to recover \$4.5 billion in taxpayer losses. Most were from failed savings and loan businesses, but the lawsuits got the full attention of board members of large banks.

These things can be done again. But regulators also need to close the loopholes that enable banks to sidestep Dodd-Frank’s Volcker rules against speculative position-taking. The Act allows broad exceptions for “market-making,” client service and dealing in government and agency securities. It also allows more than three years for banks to implement the rules, which are yet to be published. The dilution of the Volcker rules may convince the banks they can survive as flow traders.

What the Fed should do, therefore, is allow all forms of client-based trading (“market-making”) but prohibit trading positions being maintained for more than, say, 60 days. This would mean the banks can do all the flow trading they want as long as they are out of their positions within two months, so they do not end up becoming long-term proprietary trades. This rule should apply to all securities, including the government and agencies securities exempted from Volcker by Dodd-Frank.

Tightening such rules could tip the balance, encouraging the big banks to break themselves into a smaller, but still formidable public utility component, plus one or more non-systemic risk-taking enterprises. Most banks, as several analysts and active investors have pointed out, would probably create shareholder value by doing so, but they will need a push to do it.

The banks say their break-up would reduce the availability of capital for economic growth and make it more difficult for them to provide liquidity to the market. But capital markets will not implode because some banks break themselves up into more manageable, failure-tolerant pieces. Capital markets continually reshuffle talent, which can function just as effectively as shadow bankers or end-using risk-takers.

Through their current ownership interests, governments directly or indirectly control many of the world's largest financial firms now undergoing a transition. This gives them the opportunity to shape the future by forcing banks to break themselves up into fail-safe units. A UK Government commission is currently reviewing this possibility.

ING and AIG are already being broken up; [Citigroup](#) is to shed its non-banking businesses (Citi Holdings) and reconstitute itself as [Citicorp](#). The group could be pushed further into shedding all of its asset management, proprietary trading, hedge funds and private equity businesses and return to being a "pure" commercial bank. As such, it could expect to retain a strong market share as an originator and adviser in global capital markets and retail banking around the world.

This is the shape Citicorp was in when Travelers acquired it in 1998 at 3.5 times book value. Today it trades at nearer 0.7.

Roy C Smith is professor of international business at New York University's Stern School of Business.

FINANCE JOBS

POST A JOB

[Interim Finance Director - Robert Half International](#)

[EMEA Finance Director - Robert Half International](#)

[Financial Director - Robert Half International](#)

[Head of Operations Tax EMEA - BlackRock Inc.](#)

[More jobs from FINS.com»](#)

[Finance careers newsletter»](#)