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SNL NASHVILLE NOTES

Tuesday, November 29, 2016 1:53 PM CT

At KeyCorp, SunTrust, corporate investment bank units make the cut

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As far as 2016 political surprises go it is a very small one that may go nowhere: The 2016 Republican platform called for "reinstating the Glass-Steagall Act of 1933 which prohibits commercial banks from engaging in high-risk investment." During October, Donald Trump called for a 21st-century version of the Depression-era act without any elaboration.

I am not convinced that President-elect Trump has strong feelings about Glass-Steagall. My take is that there is ill will among some U.S. bankers regarding Trump's past corporate bankruptcies, based on comments I have heard and read. But it is a two-way Street. In an early Republican debate in 2015, when Trump was challenged about a Chapter 11 filing, he said "lenders are killers." Why not get even? The call for reinstatement may be a knife that fits with the false narrative that Glass-Steagall repeal contributed to the 2008 financial crisis and with the ill will much of the public feels toward Wall Street.

The Volcker Rule was a stab at reinstatement. The law theoretically limits certain "risky" hedge fund and private equity investments, while restricting trading to an agency model by precluding prop trading. The casino writes the rules, of course, and Treasuries, municipals and certain other forms of government-related debt are exempted from the prop trading restriction. In a sense Paul Volcker's simple idea of banning prop trading, which morphed into incredibly complex rules, represents a return to the old House of Morgan model of capital raising in which Morgan as a lead in a syndicate would underwrite and distribute, but would largely leave trading to others.

The reality is that Glass-Steagall had been fading for years by the time it was formally repealed in 1999. In the late 1980s, the Federal Reserve gave bank holding companies permission to establish securities subsidiaries to engage in limited underwriting and dealing in bank-ineligible securities; over the subsequent years the Fed gradually eased restrictions on the amount of revenue these so-called Section 20 affiliates could derive from ineligible activities that were defined in Glass-Steagall. Then-Fed Chairman Alan Greenspan was sympathetic to the banks' plight and argued that more competition would be good for financial services. Securities units of the predecessors to JPMorgan Chase & Co. and Citigroup Inc. were among banks awarded limited powers that were expanded in the 1990s. Most of the early efforts and successes were in the corporate debt markets given that commercial banks' expertise is debt investing. JPMorgan was the first among the group to obtain the holy grail of equity underwriting authority from the Fed in 1990.

Sandler O'Neill & Partners' Jimmy Dunne, when asked about reinstating Glass-Steagall several years ago, said something to the effect that it would not happen because eggs cannot be unscrambled. There is, I think, a good reason not to attempt to do so.

I believe corporate borrowers are well-served when the securities affiliates of commercial banks are able to provide debt and equity underwriting. A commercial bank lends depositors' money. Most of the loans are secured and have priority in a bankruptcy scenario because they are at the top of the borrowers' capital stack. Investors provide the higher-risk debt and equity capital that is arranged by the broker-dealer.

One question is, who holds the risk (and potential return)? Banks used to hold all of the loans and therefore the risk at the top of the capital structure while retail and institutional investors provided the higher-risk capital; however, the capital provider model has been scrambled, too.

Loans are not securities in a legal sense, but the corporate loan market has evolved into a capital market structure in terms of underwriting, distribution and secondary-market trading, which is particularly important because it provides price discovery. Traditional lending does not do so because loans are originated and carried at par unless impairment occurs. Corporate America is the beneficiary of the model. Banks, including Goldman Sachs Group Inc. and Morgan Stanley, provide seamless financing that straddles the loan and corporate debt markets depending upon client needs and market conditions.

All of which is a long soliloquy to SunTrust Banks Inc. and KeyCorp. Both have investment banking units that outwardly seem to be well-integrated with the corporate bank to form the corporate investment bank. Other superregionals such as BB&T Corp., Fifth Third Bancorp and PNC Financial Services Group Inc. are active in the capital markets, but SunTrust and KeyCorp seem to have made more substantial efforts. SunTrust's investment banking revenues were $461 million in 2015 and $372 million in the year through Sept. 30; KeyCorp's investment banking revenues were $445 million and $325 million, respecitvely. Both units should have a good, maybe really good, fourth quarter given lubricated capital markets that have seen credit spreads remain relatively stable and equity prices rise. Advisory revenues may be strong, too, with a rebound in markets, although middle-market M&A was off somewhat through September.

Maybe it does not matter given the years that have passed, but the nucleus of each unit that was acquired in the 1990s did not come cheaply, and these acquisitions entailed rough starts, according to Street chatter I heard at the time. KeyCorp paid $662 million for Cleveland-based McDonald & Co. in 1998. The bank later sold the retail unit, which is probably where most of McDonald's franchise value resided, for $280 million to UBS AG in 2007. SunTrust paid $149 million in 1998 for Nashville-based Equitable Securities Corp., which was mostly an institutional brokerage and investment banking firm. If the local Nashville consensus was right that SunTrust overpaid by a lot, the bank averaged down by acquiring the institutional investment banking operation of venerable Robinson-Humphrey Co. for only $10 million in 2001 from Citigroup.

Neither KeyCorp nor SunTrust is a big player in U.S. debt and equity capital markets, but the units are natural extensions for important corporate lenders in the Midwest and Southeast. Fifth Third is making a limited push into equity capital markets to complement its debt capital markets. Even Pinnacle Financial Partners Inc. has taken initial steps to offer capital markets financing so that the bank does not have to hand off financing and advisory opportunities to someone else.

Aside from making sizable investments in the 1990s to get into the business, the career paths of the heads of the corporate investment banks at KeyCorp and SunTrust may account for some of the success. KeyCorp's Corporate Bank President Chris Gorman worked in banking at McDonald before rising through the ranks at KeyCorp and perhaps had a grassroots view of how the corporate and investment banks should be integrated. SunTrust's Mark Chancy leads wholesale banking, which includes the CIB. He was a banker and later CFO at Robinson-Humphrey prior to its acquisition by SunTrust, where he eventually rose to CFO.

I doubt the Trump administration will replace Glass-Steagall with whatever a 21st-century idea of the Depression-era law would entail. There are many items on the agenda that have a much higher priority, such as tax and healthcare policies. Plus, I do not think there is a groundswell of support in Congress, especially from the New York delegation. If I am wrong, the likes of SunTrust and KeyCorp could reluctantly get out of whatever activities would be deemed impermissible. For the likes of JPMorgan and Citigroup the egg is completely scrambled after 25 years or so of integration.

Not everyone would be a loser, however. Reinstatement would create a multibillion-dollar engagement that could span upward of a decade for consultants, accountants, tax specialists and lawyers. The president-elect may have more affinity for these professionals than his lenders.

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