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NASHVILLE NOTES

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Unscrambling the egg

By Jeff K. Davis

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Last week, Sens. Elizabeth Warren, John McCain, Maria Cantwell and Angus King introduced the "21st Century Glass-Steagall Act of 2013" to force separation between traditional commercial banking, which is broadly defined as lending and deposit taking, from securities underwriting. Although there were excesses, the universal banking model that was employed by large mostly New York City banks in the 1920s had nothing to do with the stock market crash and subsequent Great Depression. Likewise, the unwinding of Glass-Steagall, which had been underway since the 1980s and was codified in 1999 via the Graham-Leach-Bliley Act, had nothing to do with the 2008 crash.

In both eras, excessive leverage, speculation and an initially slow-moving Federal Reserve were common contributors. Wall Street was not without blame in either era, and was especially complicit in facilitating ridiculously loose mortgage underwriting standards in conjunction with public policy and a housing lobby that promoted home ownership for millions who should not have been homeowners.

Citigroup Inc. in 2007-2008 and one of its primary predecessor companies, National City Bank, in the 1920s epitomized the zeitgeist of each era. CEO Chuck Prince remarked that one has to dance while the music is playing. National City Bank President Charles Mitchell was arrested, indicted and tried for tax avoidance in the 1930s, but he was found not guilty.

No doubt Sen. Warren believes in the proposed bill, but it may be intended to be a shot across the bow of the industry, even though its chance of passage is very slim. She wields considerable power in Washington over regulatory and now legislative matters that impact the banking industry given her role in establishing the Consumer Financial Protection Bureau. In time, the CFPB may prove to be as impactful as Glass-Steagall. The proposed (or threatened) 21st Century Glass-Steagall Act, which may help solidify her power, seeks to (a) reduce risks by limiting banks' ability to engage in activities other than "socially valuable" core banking activities; (b) protect taxpayers; and (c) eliminate conflicts of interest from which profits are earned at the expense of their customers or clients. Among the proposals is a five-year divestiture period, though employees, officers and directors who serve in both a bank and security, insurance or swap affiliate would have to resign within 60 days.

Sandler O'Neill & Partners LP CEO Jimmy Dunne responded to a question last year from an interviewer about reinstating Glass-Steagall as unworkable. He described it as unscrambling an egg. One analyst asked JPMorgan Chase & Co. executives during Friday's conference call if passage of the bill would negatively impact JPMorgan given its current business model. It seems like it would, just like a sustained increase in long-term rates would send mortgage banking back to 1994 if not 1980. JPMorgan's corporate and investment bank produced net income of $2.8 billion in the second quarter and $5.5 billion year-to-date, which respectively represented 44% and 42% of consolidated net income. Some of the earnings are derived from proposed "permissible" corporate lending and deposit gathering. Nevertheless, year-to-date investment banking fees totaled $3.2 billion, or 6% of revenues, while fixed income ($8.8 billion), equity ($2.6 billion) and other capital markets revenues ($2.1 billion) accounted for 26% of consolidated revenues.

CFO Marianne Lake noted that the model proved its worth in the financial crisis and that JPMorgan's customers like doing business with the company as configured.

When Wells Fargo & Co. CEO John Stumpf was asked the same question, I think he gave a more succinct answer and perhaps an answer that he would not have given prior to the acquisition of Wachovia Corp. and its robust middle-market-focused investment banking unit. Wells Fargo operates in the "real economy" in which deposits are received and then invested in loans. Doing so is "proprietary" in which risks (of being long) have to be managed. He went on to argue that helping a customer raise capital via a public offering of debt or equity does not make Wells Fargo "riskier or weaker or puts depositors at risk, more so than making a loan." Investment banking fees, which I assume exclude agent-related capital markets revenues, of $891 million year-to-date represented 2% of consolidated revenues.

In other words, Wells Fargo, JPMorgan and other large financial companies that have deposit-taking subsidiaries, are in the business of financing their client's capital structure—albeit with senior secured loans or with debt and equity in which the securities unit acts as a dealer to facilitate the financing. Underwriting and distributing a bond or equity is less risky than underwriting and holding a loan, in my view. Risks associated with the "originate and warehouse" model is why most of the large corporate loan market is now structured along the lines of the corporate bond market in which loans are underwritten, distributed and subject to daily price discovery via trading. Traditional commercial banking is hurt by the lack of regular price discovery for its assets beyond its bond portfolio.

On the other hand, Sen. Warren's and others' efforts to reduce risks to the banking system by requiring more core equity capital, especially for the largest banks that are most involved in global markets and payment processing systems, is the right thing to do. And while it is painful for banks and investors to adjust to higher capital, at least it is occurring at a time in which loan demand is tepid as reflected in both Wells Fargo's and JPMorgan's recent results.

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