

Banks fail to get in on the Act

The take-up rate among international banks to become financial holding companies in the US has been relatively low. Raphael Soifer¹ explains why he is not surprised.

From the end of last June, most major US banking groups have filed elections to become financial holding companies under the terms of the Gramm/Leach/Bliley Financial Modernization Act 1999 (GLB). However, only 14 foreign-based banking groups have done so. Four of those are Canadian, one is based in the Cayman Islands, and only one – HSBC – is British.

One securities firm – Charles Schwab – and no US insurance companies have elected under the Act to date, except of course for Citigroup, the desire of which to legitimise its birth without divesting its US insurance underwriting businesses gave the Act its primary impetus for passage.

Why so few? Some of the reasons have to do with particular features of the Act itself, or of proposed regulations, which various companies see as being unfavorable to their interests. From the viewpoint of international banks doing business in the US, some of these include the proposed balance sheet leverage requirement; the proposed way of implementing the “well-managed” standard; and the proposed limitations on merchant banking activities. All of these are currently being reviewed by the Fed and the OCC as part of the coordinated rulemaking process prescribed by the Act.

However, I believe that the most important reason is a simple one: most international banks, securities firms and insurance companies have not chosen to become financial holding companies because they have not yet seen a compelling advantage to do so.

As far as I am aware, apart from Citigroup, only two significant mergers have taken place under GLB’s provisions: Charles Schwab’s acquisition of US Trust, a leading private banking firm for wealthy Americans, and the recently-announced purchase of PaineWebber by UBS. Lawyers suggest, however, that both transactions could probably have been done without GLB, with only relatively minor changes.

As for Citigroup, it is believed it had contingency plans under development to sell those underwriting businesses had the Act not passed in time. At least in the US, insurance underwriting is not that attractive a business in terms of risk-adjusted return on capital (RAROC). The real money is made mostly in the marketing of insurance products, something which Citigroup could have continued to do had GLB never been enacted.

¹ Raphael Soifer is head of Soifer Consulting, LLC. E-mail: Ray@soiferconsulting.com. This article is based on a recent roundtable presentation to the Centre for the Study of Financial Innovation.

Jake Garn, the Republican senator from Utah who was one of Senator Phil Gramm's predecessors as chairman of the Senate Banking Committee, once observed that the Congressional legislative process tends to follow developments in the marketplace, with a lag of approximately 10 years.

It would have come as no surprise to him, then, that GLB has thus far been followed by so little change in the US financial landscape. Most of the related changes, he would point out, occurred long before Congress got around to ratifying them through this legislation.

Chief among these was the ability of bank holding companies to enter investment banking through the establishment of so-called Section 20 subsidiaries. This has been in effect for about ten years, during which banks have had growing freedom to acquire investment banking firms. Indeed, most banks which have wanted to enter investment banking in the US have already done so through Section 20. It has been argued that any bank whose shopping list in this field has not already been filled has arrived at that condition not because of regulatory constraints, but primarily because of a shortage of available, willing sellers, especially among the large bulge-bracket firms whose franchises are so desirable.

While Congress was considering this bill, prominent spokespeople for investment banking firms argued, correctly enough, that Section 20's playing field was inherently uneven: banks were permitted to buy investment banking firms, but generally not vice versa.

However, with the exception of Schwab-US Trust, a transaction which could probably have been structured to comply with prior legislation, no such acquisitions have yet taken place.

Merrill Lynch recently began offering FDIC-insured deposit accounts in Merrill Lynch-owned banking institutions to its US private clients that hold more than \$100bn of third-party money market instruments through their Cash Management Accounts. This program was launched June 1st, and approximately \$10bn of additional deposits were produced in the first month alone. It is intended to result in lower funding costs for Merrill Lynch, as well as slightly higher yields for the clients than they had been receiving before.

However, Merrill Lynch is doing this entirely under previously-existing legislation, which has long allowed securities firms to own thrifts, industrial banks and similar depository institutions which, in effect, can do virtually anything for a private client that a regular commercial bank can do. Indeed, Merrill Lynch has not even applied for financial holding company status under GLB.

One of the clearest lessons from applying RAROC analysis to banking is that holding large corporate loans on a bank's books is a very effective way of destroying shareholder value. Banks which make good money from such lending do so by

originating the loans, selling them on to others, and capturing as much fee-based income from their corporate clients as they can. Chase Manhattan, for example, retains only about 8% of the corporate loans it originates.

Investment banks are no different. While they must compete with the likes of Chase Manhattan and Bank of America for corporate finance business, their loan syndication departments have even less desire to hold loans on their books than the banks do. For their shareholders, acquisition of a commercial bank with a large loan portfolio holds little attraction indeed.

What the brokerage firms mainly wanted to get through GLB was the ability to acquire banks with large trust departments, so they could do a better job of helping their affluent private clients with estate planning and similar issues, and thus improve their chances of holding on to the assets when the generational wealth transfer takes place.

However, the shares of US trust banks tend to trade at price/earnings multiples at least double those of brokerage firms, so the economics of such an acquisition are unlikely to work for the buyer. Charles Schwab is a much larger firm than US Trust, and the valuation of its shares was greatly increased at the time by the dot-com phenomenon since it is, among other things, the world's largest online broker. All the Merrill Lynches and Morgan Stanleys of the world could do was watch with envy, and in the case of PaineWebber, get the world's largest trust bank, UBS, to buy them.

The principal change in the US regulatory environment wrought by GLB is the ability of these newly-created financial holding companies to own subsidiaries which engage in insurance underwriting within the US, alongside their banking and securities subsidiaries. This has led to much speculation about the possibility of bank-insurance company mergers, but once again, except for Citigroup, a unique company with a unique history, it has not happened.

As with corporate lending, the most important reason is shareholder value. As Dick Kovacevich, chairman of Wells Fargo, puts it, "We don't have to own the factory to sell the product." He is not alone in this thinking.

While GLB was still being debated, some of its strongest advocates were European universal banks. If a European bank wanted to merge with a European insurance company, and both had operations in the US, the US separation between banking and insurance underwriting would require one of the American operations -- either the bank or the insurance company -- to be divested within five years, which in some cases might prove to be sufficiently onerous to preclude the European merger in the first place.

However, as we have already seen, obtaining financial holding company status under GLB will impose certain regulatory burdens of its own, the specifics of which remain to be spelled out as the US rulemaking process grinds on. Whatever the resulting

rules turn out to be, the decision about becoming a financial holding company is likely to require a good deal of careful analysis.

What about the future? In the next few months, US regulators will complete their rulemaking process, and we will see what emerges. My guess, at this point, is that the final regulations to implement GLB may be a bit more liberal in some respects than the original proposal, but not dramatically so. They will probably turn out to be quite recognisable to anyone familiar with the original Notice of Proposed Rulemaking.

If that turns out to be the case, it would probably add momentum to a movement which is already gathering steam in the US financial services industry, calling for a top-to-bottom rethinking of the US regulatory structure.

Insurance companies, for example, are currently regulated primarily by the 50 states, although there is some federal regulation of certain types of insurance, notably pensions and other employee benefit plans under the Employment Retirement Income Security Act, as well as by that ubiquitous *de facto* regulator of nearly every aspect of American life, the Internal Revenue Service. Should there be explicit federal regulation of the insurance industry? Some of the larger companies believe it might simplify their lives.

Should the Federal Reserve System continue have a supervisory role in banking, or should that be transferred to the OCC, an arm of the US Treasury? Should US banks continue to have a choice between state and national charters, each with different regulators?

GLB was constructed around the concept of functional regulation, in which each function of a financial holding company – banking, securities, insurance – is regulated by a different supervisor, or set of supervisors, appropriate to that activity. While that compromise solution undoubtedly facilitated the Act's passage by avoiding potentially divisive turf battles among regulators and in Congress, many in the industry (myself included) believe that functional regulation is actually dysfunctional, by requiring and perpetuating firewalls and similar structures which tend to defeat the synergies for which GLB was originally enacted, as well as by requiring financial services companies to deal with a multiplicity of supervisors, some of which have competing interests with one another.

Should the US continue down the road of functional regulation, or would a unified supervisor such as the UK's FSA be a better approach?

Issues such as these are beginning to be discussed under names such as "regulatory reform" and "regulatory convergence." Not much is likely to surface in 2000, an election year, but preparatory work is already going on behind the scenes. Look for this debate to take public shape in the next Congress. Real change, however, tends to come slowly, after a consensus has emerged, and we seem a long way from that today.