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HISTORICALLY SPEAKING
Markets Media looks at how America's banking past could define its future.

By Riley McDermid

After America's unprecedented $700 billion bailout of the banking system and the U.S. Treasury's $250 billion injection of equity capital into the nation's banks, some small measure of relief has come to global financial markets looking to have at least a few weeks of calm following a chronically insecure year.

Still, despite sweeping worldwide efforts to stabilize markets and jumpstart intrabank lending, U.S. Federal Reserve Chairman Ben Bernanke said in late October that he fully expects the American economy to experience an extended period of difficulty as a global recession spreads. Other analysts have echoed that assessment, raising the point that even if banks have managed to survive the recent market turmoil, they are not out of the woods yet.

"If you made it past the credit crisis, you are not making it past the economic carnage," says Meredith Whitney, a banking analyst at Oppenheimer & Co., in a note to investors in mid-October. "And there is more to come."

The failure of storied investment firms Lehman Brothers and Bear Stearns, and the flight of barelyviable banks such as Merrill Lynch and Morgan Stanley to larger, more stable acquirers, has turned the banking landscape upside down.

Indeed, a flurry of mergers and bankruptcies earlier this fall led many leading analysts and pundits to declare that Wall Street as we knew it is now, for all intents and purposes, dead. But what will the new American banking system most resemble when the dust settles? Are we looking at a banking model that goes back to strict separation between investment banking and commercial/retail operations, like the old-fashioned community banking models common earlier this century? Or are we likely to see a new hybrid form of the bank holding company?

For now, many financial historians take umbrage at the idea that the world is already sounded the death knoll for Wall Street.

“Wall Street is far from dead. It has been through this before,” says Richard Sylla, the Henry Kaufman professor of the history of financial institutions and markets and professor of economics at the Stern School of Business at New York University. “It will look different, but it will live to fight another day!”

As the market waits to see how the new changes to America's fabled marquee-name banks plays out, experts are hatching their own theories about what will constitute our new system and almost all agree that greater regulation, fewer huge banks and greater capital requirements will all be inevitable.

“We are headed towards a European system of far larger banks with close government ties and heavy regulation, or at least what Europe used to have before they jumped on the deregulation bandwagon,” says Daniel Alpert, managing director for boutique investment bank Westwood Capital. The more restrictive climate is an inevitable result of the push for deregulation earlier this decade, Alpert says, as investment banks attempted to become more competitive with one another, and suffered the consequences.

Still, America has been here before, most financial historians will tell you, and has experimented with several ways to keep banks walking the fine line between creating healthy, vibrant markets and over indulging in risk.

Indeed, even the plan to recapitalize banks is neither new nor particularly unprecedented. In 1932, President Herbert Hoover created the Reconstruction Finance Corp. as a way for the federal government to steady an ailing market by lending to distressed banks, and between 1933 and 1935, the RFC bought up more than $1.3 billion of preferred stock in more than 6,000 U.S banks. Combined with the recent establishment of the Federal Deposit Insurance Corporation (a federal regulator that has played a major part in the nation's latest bailout plan), the government believed it had established a crucial balance that would keep the market stable for the long-term.

And it did, for most of the 20th century, avoiding most bank panics -- which had been a staple of the nation's earlier banking history -- and slowly evolving into the universal banking model familiar to most American consumers today. Ultimately, more regulation was needed, however.

“We've now seen the two dangers of the current system. Mono-line banks, including mortgage banks and investment banks, had two Achilles heels: they did not have adequate access to capital and they were not properly diversified," says Scott Talbott, senior vice president of government affairs for the Financial Services Roundtable, a banking industry think tank. "So, as the country moves forward, we will see a new phase of banking that is dominated by universal banks, where large financial institutions will handle most of the transactions from operating branches and checking accounts to IPO's, to advising on mergers and acquisitions, and even some securitization and trading."

That is precisely the case now, experts say, as the U.S. faces a crossroads that will determine how to best restructure a market scrambling to reinvent itself as both safe and effective.

"Innovation is healthy to a point as it increases the productivity of the economy. But totally unregulated innovations in financial markets always devolve into excessive leveraging and unsustainable risk taking," says Talbott. "Our challenge will be finding ways to regulate that avoid the potential negative excesses of innovation without stifling innovation itself."

That challenge has presented a problem to U.S. regulators before. After most Americans blamed the market crash that brought on the Great Depression on greedy commercial banks willing to risk deposits on the stock market, Congress passed the Glass-Steagall Act in 1933 as a way to separate lending firms and brokerages into two separate categories. Those two camps stayed separated for most of the 20th Century, with Americans taking their long-term investing needs to brokerage firms and conducting most of their other banking business at separate, often community or regional, banks.

That wall of separation stood for more than six decades, but eventually fell prey to an increased push by U.S. banks to be globally competitive and newer market principles reviewed by regulators and found to be acceptable additions to existing regulation. As a result, Congress passed the Graham Leach-Bliley Act in 1999, a statue which allowed investment banks and commercial banks to consolidate and ushering in the age of "universal banking" known to most American consumers today.

Alpert says the blame for much of the trouble experienced by banks over recent quarters can be laid squarely at the doorstep of the federal government's elimination of Glass Steagall in the late 1990s.

That "coupled with absurdly low interest rates, below the rate on inflation for most of this decade, from the Fed, effectively subsidizing borrowing. Those two things, plus just stupid, lax, and irresponsible lending, are where you can start writing the history of this financial decade," says Alpert. "Allowing looser capital requirements was merely a symptom of the elimination of G-S. Investment banks couldn't possibly compete responsibly against institutions with a federally insured deposit base. So they asked to compete irresponsibly in order to survive, and they asked that of hands-off regulators and know-nothing legislators."

Sylla disagrees that the repeal of Glass-Steagall itself was the central catalyst for the ultimately fatal policy changes that banks enacted, but says that it did symbolize a sea change in how regulators and bankers thought about regulation.

"The anti-regulatory spirit of it and other legislation was a factor," says Sylla. "A lot of people really believed that the market can do no wrong and government for the most part can do no right with respect to economic life. They were wrong."

As a result, Sylla says, "that 2004 decision was not helpful, and I expect Henry Paulson who lobbied for it at Goldman is now having second thoughts about it in Washington."

"In some cases it led to a doubling of leverage ratios, making any decline in asset prices twice as likely to bankrupt an investment bank," he added. "It didn't take long, three years, for the chickens to come home, down to roost from their flights of fancy."

Sylla says he believes that the recent vogue in turning existing investment banks into bank holding companies will continue, eventually resulting a dozen or so giant megabanks and bank holding companies and thousands of regional and community banks. As such, Sylla says he believes banks will not need a rock-solid statute similar to earlier efforts legally requiring a separation of lending and investing activities.

"I doubt we'll go back to the Glass-Steagall separation; it was the 'solution' in 1933, but the standalone investment bank is one of the problems in 2008, so a 'solution' this year has been to fold investment banks into megabanks, such as Bear, Merrill," Sylla says.

For its part, Wall Street will simply have to find a new, and smarter, way to do business. As such, a wave of consolidation will be a boon for the many smaller, more conservative investment banks that have long succeeded at attracting clients interested less in exotic investments than reaping reliably steady gains.

"We will continue to have a number of 'boutique' investment banks that stick to their knitting and don't leverage up to 30+:1," says Sylla.

Alpert added that investors burned by bad bets by banks made on everything from the American mortgage market to trading consumer debt will be looking for more conservative financial advice. That will create an ideal environment for a new sort of investment bank, he says.

"Traditional investment banks, in the model of Lazard and Warburg, giving advice and

arranging deals, will return to prominence as well," says Alpert. "Oh, my God, the return of agency business to Wall Street, what a thought!"

And the days of banks being too big to fail are over, Talbott says, as the world and the U.S. in particular moves toward greater regulation as a way to protect the financial system from the sort of massive shock it experienced earlier this year.

"The large diversified financial companies could be viewed as too big to manage, and therefore pose too much systemic risk," he says. "Policymakers will respond by increasing oversight over the industry and modernizing financial regulators to account for new risks."

Other experts, such as Federal Reserve Governor Randall Kroszner, a former economist, echoed that assessment, saying the main change to the American banking system after 2008's wild ride could be the investor flight toward more conservative banking practices.

"There may also be an opportunity for some institutions to benefit from more traditional, 'bread-and butter banking,' with exposures and risks tied more closely to bank balance sheets. This potential opportunity for niche banking could have certain benefits, as clients and investors, because of the fear of contagion, seek institutions that are specifically not involved in multiple markets and activities," said Krozner in late October. "And local banks can often provide more personalized service and have a better understanding of their clients' needs. In such cases, however, institutions conducting specialized or local business must understand the inherent risks, such as potential risk concentrations."

Some pundits, too, have posited that in a time of cash-strapped banks, private equity could be the new investment bank, as investors struggle to keep some form of the formerly cash-rich "shadow" banking markets open. But will this equity model also succumb to the same wave of consolidation and proposed regulation that has recently pressured hedge funds?

Sylla says that to an extent, private equity was the original investment bank, and points to JP Morgan's private lending and sponsoring of public equity and debt earlier this century as an example. But he predicts that both private equity and hedge funds will now face a renewed wave of regulation as investors attempt to more closely monitor them in a bid to improve transparency. Sylla says that push could result in more public transparency and more interaction between regulators and financial institutions in cases when firms may want to avoid public disclosure—an evolution he says he welcomes.

"If Wal-Mart has a computer system that tells the folks in Bentonville, Ark., how fast certain items are flying off the shelves, why can't regulators get similar timely information indicating that subprime mortgage lending is growing two or three or four times faster than the GDP?" says Sylla. "Not knowing such information is how everyone involved, bankers, borrowers, and regulators among them, got into this mess."

Talbott agreed with that assessment, adding that any healthy, modern banking system can benefit from having a thriving shadow banking system that exist solely to aggregate investor money and then deploy it into attractive investments.

"Vehicles such as these grow outside of traditional channels when there are favorable accounting, tax or regulatory environments," says Talbott. "Like all other financial intermediaries they can be a valuable part of promoting economic growth, but like all other financial intermediaries they are prone to excess unless their exists an adequate supervisory oversight process.

Still, despite the multiple roles that private equity and hedge funds can play in the rebuilding of the market by providing some of the most reliable liquidity available, Alpert says he doubts that private capital funds will move toward a more traditional investment bank model anytime soon.

"They are not run as investment banks, they are staffed too thinly so that their owners were able to profit as they have been. Either they will have to bulk up their staffs on the deal creation side and actually provide advice to the companies they are financing, or they can't possibly be looked at as 'investment banks,'" says Alpert. "I am old fashioned enough to believe that an investment bank's principal function is to advise their clients on financial alternatives, and then to match their clients needs with the most suitable, or most aggressive, capital source, be it private or in the public markets. I don't see the hedgies and PE funds in that role."

Alpert points out that there will always be investment funds and there always have been, but that the market's most recent version of some of those funds became prohibitive for many investors and ultimately could not survive the market's pressure.

"We were paying ridiculous fees to folks that profited only because they put our investment capital under enormous risk with vast amounts of leverage. I think those foolish enough to entrust their funds on that basis will have second thoughts when all is says and done," says Alpert.

And as investors and shareholders revisit the structure of many funds' management, the products will likely change to make them more durable and able to withstand future fall-out. "**Compensation**

arrangements will change and ROI expectations will drop for many. But private capital formation entities will be with us in some fashion, in a sense they always have been, but without the massive leverage they were able to position these past years, which made their function seem so critical and impactful," says Alpert.

But Alpert added that historically speaking, financial markets nearly always manage to find a way to make the same mistake twice, or thrice, or even more often, if given enough time.

"The definition of 'any time soon' in financial services industry is apparently seven to 10 years," he says.

"After that, everyone forgets and makes the same mistakes in more disastrous ways."