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Glass-Steagall Redux

By Len Blum, Managing Director, Westwood Capital LLC

In 1999, Washington repealed the Glass-Steagall Act, which separated commercial and investment banking. Since then, commercial banks, fueled by low-cost deposits, have entered the world of investment banking. Core deposits allow these banks to hold illiquid positions (or, at least, illiquid at their marked levels), without regard to market sentiment.

While commercial banks rely on deposits for funding, investment banks borrow in the capital markets, predominantly on a short-term basis. Consequently, when confidence erodes, investment banks can find themselves unable to tap sufficient liquidity.

This problem is exacerbated when an investment bank holds illiquid long-term assets—especially if they're held at marks that cannot be quickly realized. Take, for example, the unfortunate case of Lehman Brothers, whose assets were illiquid, mismarked and underwater. When market confidence plummeted and Lehman couldn't raise funds, it was unable to sell assets rapidly. Make no mistake, Lehman's asset and funding problems are intertwined; the opacity and mismarking of the company's positions destroyed market confidence.

Must Morgan Stanley and Goldman merge with commercial banks to survive? Yes and no. While they may choose to (or if the market loses confidence, they may forced to), there are other ways for investment banks to remain independent. The most critical is daily, disciplined marks of the institution's books, at levels where sufficient portions of the portfolio could be sold, if necessary. This must be coupled with careful asset/liability management, through which long-term holdings are funded with long-term debt or equity.

Given the strength of their balance sheets, the reported integrity of their marks and their robust franchises, Morgan Stanley and Goldman may have the option to remain independent. But if the market irrationally loses confidence, the decision could prove to be a bad one. Conversely, management may determine that access to core deposits is sufficiently attractive to warrant a merger (although this may be better achieved during stronger market conditions). In contrast to Merrill, Bear and Lehman, however, Morgan Stanley and Goldman may have a choice.

There is, however, one unfortunate reality: Regardless of how conservatively run Morgan Stanley and Goldman are, and despite their well-marked portfolios, if the market demands consolidation (by driving down security prices), its desire will become a self-fulfilling prophecy. When you depend on the capital markets for survival, they become your master.

There are significant advantages and disadvantages for an investment bank to become part of a depository institution. The chief advantage is access to low-cost core deposits. The greatest disadvantages are culture clashes and contrasting management styles; investment banks typically require significant flexibility to change plans quickly and adapt to markets.

There are also vital ethical issues. Tantamount is conflict of interest. How can a lender issue securities for its borrower without raising regulatory eyebrows? Consider the case where the borrower faces major hardship if it's unable to issue securities. Is it in the underwriter's best interest to disclose risks to potential investors? Glass-Steagall protected investors from this scenario.

The easiest way to prevent conflicts is to enact regulation that prohibits a bank from underwriting securities or acting as a financial adviser for any entity to which it lends—similar to the rules forbidding accountants from acting as consultants to their clients.

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