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TRYING TO MAKE A DOLLAR OUT OF 16¢

When Teddy Roosevelt established his Bull Moose party, the opponent he ran against, William ~~Jennings~~ Bryan, had popular ditty chanted about him, and it was "Bryan, Bryan, sitting on a fence, trying to make a dollar out of 16¢". The reference of course was to his being ~~Bryant was~~ a free silver monetarist. We have gone from worrying about free silver to now being concerned about the livelihood of the financial services market place.

The 1980's have brought ~~with them~~ to us an economic upheaval in how financial institutions wish to relate to one another and be identified. We are finding stock brokerage firms trying to re-package themselves to look and act like banks but yet not be regulated as a bank. We have insurance companies who are acquiring and being acquired by banks, savings & loans and brokerage firms to sell their captive customer base products that were not designed for their customers. We find that the entire financial community of banks, savings & loans, brokerage firms, insurance companies and true financial service corporations such as American Express are all vying, jockeying and competing for someone else's share of the financial market place.

The purpose of this paper is to explore what has caused this to come about now, what the participants hope to accomplish, why they are driven to this new endeavor, what are the pitfalls of their undertaking and are there really opportunities out there for them to grasp.

Some say that Changing economic factors are the underlying cause for this

phenomena to now be occurring. In the 1970's, we witnessed a new era of inflation. Inflation brought with it high interest rates, budget deficits and increasing trade deficits. Just the advent of high interest rates themselves had a devastating impact on banks and savings & loans. Traditionally, these institutions garnered money at a cheap interest rate and lent those funds out at a higher fixed rate and profitably lived off of what was entitled "the spread". In their scramble to maintain the spread and yet continue to have liquidity, in the 1970's they were forced to seek the regulators' approvals of providing interest-bearing accounts that had shorter durations, lesser early withdrawal penalties and higher interest rates. As we all witnessed, the public flocked to these accounts. The offset to paying higher interest is to charge higher rates on your loans. The banking community had the flexibility to do this with their commercial loans and thus were able to avert the calamity that befell the savings and loan industry. There the institutions were hindered with having long-term loan portfolios guaranteed by real estate at fixed interest rates. While, traditionally, real estate loans turned over every four to seven years, the inflationary environment was causing the portfolios to stay for a longer period of time due to the public's inability to refinance or borrow funds at the new high interest rates. This caused the savings & loan industry to march quickly toward one or more types of adjustable home loan interest rate mortgages. In their quest to achieve these new types of loans, they discovered a Pandora's box. They found that the regulators

who oversaw them were willing to provide loopholes in their regulatory options that allowed these institutions to do things that, if one read the Glass-Steigel Act of 1933, one would not have believed possible. This act was created in 1933 to protect the public from the manipulations that the banking industry had been embroiled in in the 1920's and the early 1930's.

At that time, a bank could not only make commercial loans and home loans, they could also deal and offer insurance and stocks and bonds, the latter not only as an agent accepting and executing trades but as a principal making a market in securities through buying a stock at one price, holding it in their inventory and selling it out at a higher price - in some instances, not only making the market but making the price for their own profit. I am sure you can easily guess whose funds they used in that time to play these wonderful games, and you are right - it was their savers' funds. Hence, being simplistic legally, the Glass-Steigel Act separated the banking community from the brokerage community and the insurance industry, and it restored the saver's confidence in his financial institution, knowing that his funds were not going to be played with, and further that there was a new safety net to protect his funds, which was what we know to be today the Federal Deposit Insurance.

By the time that the financial institutions ~~is~~ are able to tie together all the loopholes they are finding in the regulations, the legal framework that has been separating these institutions in their playground will almost be of little value. The irony, though, is We are witnessing what is loosely referred to as deregulation

Oxymoronic: a figure of speech in which contradictory terms are brought together for emphasis

that, while the regulators are providing the impetus for the loopholes for the expansions, a subset ~~(?)~~ of them are becoming inquisitors, searching for security violations and violators with more enthusiam than they had in the past. truly oxymoronic! ~~This oxymoronic approach is truly appalling.~~ The reasons we find the financial institutions ~~are~~ driven to this new quest for expansion and to market places previously denied them is for survival. at the same time as deregulation came Comment disintermediation one flow These have found that business plans and business strategies, no matter how well conceived, do not function in a market environment where interest rates are uncertain, inflation seems to become a periodic reality and budget and trade deficits are an overhanging menace. Traditionally, each type of financial institution had a market environment ~~in~~ which, when ~~this~~ it day came to pass, was in ~~its~~ the heyday of profit-making. Banks achieve this when interest rates they pay out are reasonable, ~~and~~ the monies that they loan are assured of repayment and the spread provides them the opportunity for growth, banks this is in a non inflationary amount. A stock brokerage firm that deals in common stock makes money as interest rates go down and the stock market rallies. Stock firms that deal in bonds make a profit when the common stock market is falling. Here, historically, people switch from equities to fixed investments, creating security and tying down income. The parallel continues in the insurance industry. Life insurance companies do extremely well in periods of uncertainty because people desire a comfort level to protect their loved ones in case of a disaster. On the other hand, property and casualty insurance companies, these being ones that insure homes against fire and theft and automobiles

against accidents, historically do terrible in inflationary periods. The basis for this is that they have insured an individual against a loss where their costs for paying off the loss in inflation dollars are ~~lower~~ higher than the absolute dollars that actuarially have been written into the policy. Financial service companies such as American Express, VISA card, Diners Club and Master Charge do financially well when inflation picks up and interest rates rise. They become the vendor of short-term 30-day loans with truly adjustable high interest rates. One financial service industry that, ~~while we have overlooked in our paper,~~ is now an emerging industry and ~~is able to~~ play a dominant role in our market place is real estate syndications. Here inflation and high interest rates play a positioning role by locking out private investors from the opportunity of buying income property on their own. They create a market for them to join together and buy as a syndication. So it is obvious what these financial institutions wish to accomplish by acquiring their counterpart business partners, and that is to lessen the impact of the uncertainty of the market place on their earnings and, in some cases, to provide them with a substantial new revenue stream of earnings that had been denied them before.

What does the future portend? A move to become a product manufacturer, distributor and retailer. (I contend) no longer will they be content with just providing monies. A primer example of this can best be seen by reviewing the new role they are defining for themselves in the world of real estate and real estate syndications. Historically, a bank would lend the construction money to a developer and once the project was completed, the developer would seek what is referred to as a take-out loan from either a bank, insurance company or a savings & loan. Once that had been accomplished, the developer would either hold the property for one to five years to achieve the tax write-off benefits or sell it to a third party who, in many cases, syndicated the property; thus dividing the ownership up into bite-size units and offering each to private investors. These investors would be attracted to the program because if the property, for example, was residential income, the carrot offered of doing a condo conversion whereby the property would be sold as individual apartments was extremely attractive. Profits of 50-60% were not uncommon. This turns out to be the classic case where the sum of the parts is greater than the value of the whole. Hence, the condo converter makes a substantial profit while the poor bank or savings & loan only walk away with the loan interest. As you might surmise, the financial industry is unhappy with this phenomena and have taken steps recently to totally change it. We find, as an example, that Balcor, the largest syndicator in the U. S., has been purchased by Sears. There also have been many savings & loans who have started to

implement equity participations as a component for their making a loan to a developer or a condo investor. Some savings & loans have created their own syndication companies and become distributors. Other savings & loans are taking an even more dynamic role and have started to create joint venture partnerships to not only distribute but to retail to their own customer base. The entire trend is for the financial instituion to be an equity participant through the entire life cycle of real estate.

When we look to determine what are the pitfalls of such activities, one where we have a bank and a savings & loan and an insurance company and a brokerage firm all coming together under one umbrella, we find that the major pitfalls appear to be the lack of multi-disciplinary management capabilities. Far too often, the brokerage firm is found to be making banking decisions while still wearing their broker's hat and don't have the depth of knowledge needed to envision the long-term impack of their decisions.

A second pitfall is that the financial institutions grouping together under one corporate umbrella in many instances are turning out to be one strong operation with two or three weak sisters, weak in the sense that in each institution's economic heyday, when it comes, it doesn't provide the same number of absolute dollars of profit as the others. As an example, we have a bank combined with a brokerage firm that, when the bank is profitable, it makes $200 million in profit and yet when the brokerage is profitable, it only makes $50 million in profit, and hence its contribution to providing stability in the bank's down market does not have as

much substance as is needed.

Are there really opportunities out there in the market place? One might conjecture that we are embarking on a disaster. The use of accumulated earned surplus or, worse yet, borrowed funds (a la leveraged buyout(s)) to purchase businesses that one knows little or nothing about could make trying to make a dollar out of 16¢ very frustrating.