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FROM BANKER TO BOOKMAKER – A COLLISION COURSE OF EXPECTATIONS ABOUT THE MEANING OF "INTERMEDIARY"

Last week's allegation of fraud by the U.S. Securities and Exchange Commission (SEC) against investment bank Goldman Sachs raises larger issues about trends, perceptions and expectations in the financial industry generally. This article does not discuss the Goldman case. (For DBRS analysts' views on the Goldman situation, please refer to the DBRS press release published on April 16, 2010.) Instead, it addresses some of the broader aspects of the evolution of the banking and financial markets in recent years, and the potential confusion in the minds of clients about the role being played by bankers in particular transactions.

In what has been a multi-stage transition over several decades, banking has evolved from an industry where banks were "principals" in the transactions they originated to one where they now offer a wide range of products and services. In some transactions, banks still play a role as principal, in others they are merely booking bets by clients on the outcome of events in which the bank may have no economic interest. Indeed, in some cases they are booking bets by clients on events in which the bank itself may be betting on the opposite result.

None of this is inherently wrong or illegal, per se, but it can be confusing to clients and the public, especially if the role of a bank in a particular transaction is not fully appreciated by the client. This issue is at the heart of current – and perhaps future – cases that the SEC, other regulators and private litigants may be working on.

What's in a Name: "Intermediary"

The term 'intermediary" originally applied to the straightforward role of banks taking deposits from savers and lending the money to borrowers. They "intermediated" both in terms of the flow of funds from one to the other, but – more importantly – they took the risk of the borrower's non-performance. Many banks – especially smaller and/or community banks – still follow this basic business model. But the traditional model began to change – albeit only slightly – several decades ago when larger banks began to "participate" portions of their loan portfolios to other banks. This started out as an accommodation provided by the money-centre banks to smaller so-called "correspondent" banks ("country banks") that relied on their larger brethren for various services. These services often involved international banking (foreign exchange, international remittances, export and import letters of credit, etc.) or trust and money management services, but also included providing the smaller bank with earning assets when it had excess space on its balance sheet. The larger bank, while retaining the bulk of each loan on its own books, would transfer small participations in individual loans to its correspondent bank, which generally relied to a large degree on the larger bank's credit analysis and judgment.

This practice – having begun as an accommodation by city banks servicing country banks – eventually grew into the loan syndication business, where major banks originate large loans (sometimes in the billions of dollars) and distribute them to hundreds of investors, including other banks, non-bank institutional lenders and mutual funds. As the business grew, syndicating loans became the preferred business model for the major banks. They discovered that they could earn more money by originating loans – many loans – and passing them through their balance sheets, collecting fees on each, than they

could if they originated a smaller number of loans, kept them all on their balance sheets until maturity and collected the interest income. This is now the model for most corporate lending in North America and Europe, where a dozen or so large banks originate most of the major loans, and syndicate them to a broad network of other bank and non-bank investors.

Banks are still considered intermediaries, but now the concept of intermediation has broadened beyond merely transferring the cash from depositors to borrowers, while keeping the risk. Now the bank is intermediating not only the cash, but also the loan asset itself, including the risk. As this happens, the bank transforms its own role away from being a principal to that of a broker or sales agent (at least for that part of the loan that it has sold; it still may continue to hold a portion.)

Interests Still Aligned

But even at this point, while banks may have every incentive to arrange the maximum number of loans, distribute them to a wide investor audience, and collect all the fees they can, their interests are still largely aligned with the investor clients to whom they are selling the loans, for several reasons:

- The originating bank typically retains a piece of the credit (they have "skin in the game");
- Both sides of the transaction have a vested interest in a successful deal (i.e., neither the borrower nor the investor/lender has any interest in the borrower defaulting or going bankrupt); and
- Originating banks have a strong reputational interest in having the loans they underwrite be successful.

This strong alignment between the originating banks' interests and those of their clients has been eroded gradually by the rise of credit default swaps and similar derivative instruments that allow banks and other investors to take positions either way with respect to a particular client's creditworthiness. During the 1990s, a number of large banks – including some large Canadian lenders – pioneered the use of "portfolio theory" to analyze and manage credit risk, in order to reduce the skewing of risk in the bank's portfolio that arose as a result of regional concentration or a bank's historical expertise in particular industries. As a consequence, the credit default swap (CDS) market arose in part to meet the needs of lenders to balance their portfolios and diversify credit risk. But while many banks may use the CDS market extensively to reduce risk on individual credits to manageable, portfolio-appropriate levels, there have been no cases that we have discovered in which banks have deliberately made offsetting negative bets against the performance of loans that they had originated and sold to other investors.

This means that – despite the legal disclaimers that are an integral part of loan syndication and trading – there is still an implicit understanding in the loan market that the bank originating the loan (the "lead" or "agent" bank) has structured it professionally and wants it to perform satisfactorily. In other words, it is assumed that the bank, in structuring the loan, has intentionally created an "investment," with all that word implies about the asset having inherent value.

"Investments" vs. "Bets"

But this assumption that the assets bankers create are investments, and have some intrinsic value, does not apply to the creation and sale of derivatives. Derivatives are wagers on the behaviour of some other asset. You can wager on the direction of interest rates, currencies, equities, commodities, etc. Of course, you can also bet on the creditworthiness of a corporate borrower, perhaps the same corporate borrower whose loan you may be holding.

By definition there are two sides to every bet. So if a client comes to the bank and wants to bet for or against some event occurring, the bank can either (1) take the other side of the bet itself, or (2) find another client willing to take the offsetting position; just like the bookmaker who can only accommodate a big bet on a Stanley Cup playoff game if he finds someone to bet on the opposing team.

Banks are now playing both roles: (1) the traditional role of the loan originator/deal structurer that creates instruments with intrinsic value and offers them to clients as investments (often with some of their own skin in the game providing additional incentive for the deal to be successful); and (2) the role of trader/bookmaker that buys and sells assets and facilitates wagers by clients on specific outcomes about which the bank itself is largely indifferent.

In the first situation, the banker is still selling its traditional competence in analyzing credit and structuring solid transactions. Most investors – even if they may have legally disclaimed any recourse – are in fact relying on that in their investment decision. In the second situation, the bank is selling its ability to access a wide range of markets and instruments, to offer attractive prices and execute dependably and efficiently. But unlike the first situation, in essentially placing a bet for the client there is no implicit warranty or recommendation by the banker that one side of the bet is preferred to the other.

Bankers and Their Clients – Today

The distinction between bankers' two roles – principal and bookmaker – has become fuzzy in recent years, and it appears that even very large, supposedly sophisticated clients have become confused about which role their bankers were playing and how much they could rely upon them. Defining the role becomes even fuzzier if the derivative instrument (i.e., the bet) is not a straightforward wager on an existing transaction or future event (e.g., the direction of interest rates, foreign exchange rates or equity prices) but is, itself, a highly structured transaction. A derivative bet consisting of a synthetic collateralized debt obligation, which involves multiple layers of bets on the behaviour of other debt instruments that themselves are individual tranches of complex securitized vehicles, is actually much more complex and difficult to analyze than the typical corporate loan. So an institutional investor, presented with the opportunity to invest in such an instrument by a major investment bank that had originated it, might be forgiven for assuming that the investment bank offering it actually believed it had some intrinsic value. Investors might be less disposed to buy the instrument if they realized that – at best – the bank regarded it indifferently as a wager with a 50-50 chance of going either way, or – at worst – that this was the bank's attempt to "lay off" the risky side of another client's deliberate – and perhaps highly informed – bet that disaster would strike.

As the SEC/Goldman litigation proceeds and other cases arise, we will likely see two critical issues emerge and hopefully become clarified:

(1) Legally, we will learn what level of care banks should be held to in ensuring that their clients understand the role the bank is playing with respect to that transaction; how much can the client rely on the bank's due diligence, is its role conflicted because of relations with the client on the other side of the transaction; is the banker playing its traditional banker role, or is it closer to that of a bookmaker?

(2) On the public policy front, we will see regulators and politicians address the issue of how much these two different roles can and should be combined in institutions that are ultimately supported by a taxpayer-funded safety net. Will politicians who accept the principle of supporting banks that provide traditional financing for corporations decide to draw the line at using taxpayer dollars to back up what they may perceive as casinos?

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