Monasteries, Mutuals and Investment Banks

BY ALBERT J. BRENNER, CFA

I RECENTLY FINISHED READING C.J. SANSOM'S HISTORICAL mystery *Dissolution*. The book is set in England in the early years of the 16th century at the time of the dissolution of the monasteries. The monasteries were dissolved by Henry VIII as part of an ostensible reform of the English church. The motivations behind and the purposes of the dissolution were many, some noble and some not. The stated purpose was to root out the corruption and vice that—according to Henry and his advisers—had become endemic throughout the monasteries (a view subject to considerable disagreement among modern historians). The dissolution of the monasteries was also intended to eliminate the influence of Rome over the newly established English church with the king as its head.

A less noble motivation behind the dissolution was the expropriation by the Crown of the wealth of the monasteries—their lands and accumulated treasure. Even in the early 16th century, many of the monasteries were centuries old. Through generations of bequests, many of the monasteries had accumulated considerable wealth; and it was no inconvenient consequence of their dissolution that this wealth flowed to the Crown and its supporters.

While I was reading Sansom's historical postscript to the book, I was reminded of a much more recent phenomenon with odd parallels to the dissolution of the English monasteries five hundred years ago: the wholesale conversion of mutual savings institutions to publicly owned stock institutions. The mutual savings industry, a relatively small component of the American banking system but a larger component in certain areas such as New England, has been around since before the Civil War. Many mutual savings banks in New England were established in the 1840s. These institutions, established to serve the small saver within their communities, provided banking services to the general public for more than a century and survived some of the most severe financial crises in American history. In the process, they made money, and their accumulated earnings were stockpiled as capital. By the late 20th century, many of the mutual banks had strong capital ratios—although some did not.

The mutual savings bank industry survived for more than a century until the management of the industry realized that they could tap into the accumulated capital of the mutual banks. Under the guise of raising capital to be more competitive, many mutual savings banks converted to stock ownership. Two things happened as a result.

About the Author

Albert J. Brenner, CFA, *is the executive managing director of Asset Allocation Parametrics, LLC, an investment research and advisory firm that specializes in providing asset allocation guidance for tax-exempt and tax-deferred investors. He is also the editor of the* Asset Allocation Advisor.

Prior to founding Asset Allocation Parametrics, Brenner worked in the non-profit and banking sectors. He was the director of finance and operations of a non-profit organization in Connecticut for six years after working in banking for twenty years. His last position in banking was as executive vice president and treasurer of Northeast Savings, a multi-state thrift institution now part of Bank of America, and where he managed more than $2 billion in assets.

Brenner is a graduate of the University of Notre Dame and holds master's degrees from Oxford and Yale. He earned the Chartered Financial Analyst designation in 1991.

Many people, and management in particular, made a lot of money. Through the grant of stock purchase rights (flowing ostensibly from being current "owners" of the bank by being current depositors or bank employees), bank managers essentially cashed out the accumulated capital of the institutions. One hundred years of stockpiled earnings were distributed in one fell swoop to the folks in the corner offices. The wealth of these community institutions, intended to serve the general public, was effectively expropriated by management. Unlike the dissolution of the monasteries, however, which led initially to a significant uprising, the conversion of the mutual savings banks had little opposition. Current depositors were able to join in the plundering, and few voices were left to speak out in opposition to the expropriation.

Ironically, the second consequence of the wholesale conversion of the mutual savings banks—at least in New England—was the ultimate failure of many of the institutions. So much capital flowed into the region, and banks were so eager to put the capital to work, that a boom in commercial real estate followed as project after project got funded without anyone asking how all of the projects could be supported. Just like the more recent national housing bubble, all of the building couldn't be supported. Commercial real estate prices dropped, buildings sat vacant, and banks failed—even those that hadn't raised new capital. Rather than buttressing the banks, the new capital resulting from mutual to public conversions precipitated a banking crisis.

As I was discussing these reflections with my intern, Jay Murray, he brought up another parallel: the conversion of the investment banks from private partnerships to publicly owned stock institutions.

Investment bankers have always been a rare breed in the world of American commerce. The traditional investment banking houses were elite institutions of moneyed individuals who put their wealth at risk to promote the growth of American commerce. Although investment bankers were wealthy individuals—or got to be wealthy individuals—their wealth was not particularly liquid. As anyone who has read Charles Ellis's history of Goldman Sachs (*The Partnership: the Making of Goldman Sachs*) knows, the accumulated wealth of the Goldman partners was typically locked up in the capital of the firm. The success of the partnership required that the pool of the partners' equity be maintained to support the underwriting and financing activities of the firm.

The conversion of the American investment banks from their traditional private partnership structure to publicly traded stock companies changed the entire dynamic of investment banking, as it gave the partners of the investment banks a means of getting more ready access to their accumulated wealth. The conversion to public companies did not constitute an expropriation of treasure accumulated over time—as in the case of the monasteries and the mutual banks—but it did change the dynamics of the investment banking world, and almost certainly for the worse. Investment banking partners were now playing with not just their own money, but also their shareholders' money. Rather than being just owners, they were now also agents.

The introduction of individuals acting as agents inevitably introduces agency problems, as they are known in the theory of corporate finance and management. Agency problems arise when the interests of owners or providers of capital are not perfectly aligned with the interests of those acting on their behalf. The private partnership structure of investment banking kept agency problems to a minimum. The partnership imposed discipline on those who acted in their own interests to the detriment of the firm. The conversion from private partnerships to public companies made thousands of investors silent partners with the in-house partners of the converted firms. The potential for significant agency problems came with the conversion. The failure of Lehman—and the near failure of several other investment banks during the latest financial crisis—is testimony to the elevated degree of risk that the banks were willing to take when playing with more than just the in-house partners' money. It would be extraordinarily disingenuous for us to imagine that the systemic risks associated with the subprime mortgage debacle would have escaped the notice of the major investment banks had they been private partnerships.

In the end, although the change in the structure and ownership of American investment banks did not constitute a direct expropriation of treasure accumulated over time, the financial crisis facilitated by the changes have amounted to the same thing—with the exception that, in the current case, a good deal of the expropriated wealth is coming from the future, not the past.

If there is a lesson to be learned from these stories, it is a cynical one. The surest way to individual wealth is to locate a store of accumulated wealth and find a way to expropriate it. Whether it be centuries of gifts, decades of retained earnings, or inflated housing values, if we can just find a way to tap the wealth, we can get rich without really trying. ■