SUMMERTIME BLUES

"I'm gonna raise a fuss and I'm gonna raise a holler…"
Time was, presumably, when central bankers were calm and unruffled.

Not any more.

Bankers and those who do their best to regulate them may well be thankful that this summer is drawing to a close. It's been a tough time for both sides.

Central banks and their associates have to operate in two parallel universes: in one, they draw up rules to try to minimise the risk of a crisis happening in the future. In the other, they have to deal with the consequences when, inevitably, given bankers' ingenuity, it does. In both worlds, the past few months have kept them busy.

The Great Deleveraging
Regulators, the commentariat, the media, the public, the bankers themselves, they all have opinions – quot homines, tot sententiae, as they say. But at least all sides agree on one thing: banks have to be less risky. Which leaves just a simple question: how?

Putting aside for now the vexed question of whether investment banking should be ring-fenced from retail banking, and if so how powerfully that fence should be electrified, the current debate both sides of the Atlantic revolves around how much more capital banks should carry in the form of equity rather than debt. Or, to use the jargon, how far they should deleverage.

It's a measure of how little equity capital banks currently hold that many City boardrooms express concern at the UK proposal of a "leverage ratio" as low as 3%. That is, banks would borrow 97p for every £1 of risk they take on. To put it another way, if a bank's risk-bearing assets were to lose more than 3% of their value, the institution would be insolvent. If the man in the street were to conduct his financial affairs on that basis, his bank manager, supposing he could find one, would read him a very stern lesson.

Banks, of course, are different: they're too big to go bust.

So how much is enough?
To put the proposed 3% in perspective, US banks in the 1880s carried around 25% of equity on their balance sheets[1]. Perhaps with this history in mind, US regulators are suggesting 6% for the biggest banks, while a recent bill in Congress called for as high as 15%[2].

So how has the role of equity shrunk so much? There are arcane arguments about the tax advantages of using debt rather than equity to build a balance sheet. But surely a major factor must be investors' historic focus on ROE as a measure of bank performance (and, it has to be said, as a driver of bosses' bonuses). Even now, City analysts apparently see 10% ROE as the bar. So perhaps

[1] *London Review of Books*, 9 May 2013
[2] *The Economist*, 20 July 2013

it's not a coincidence that Antony Jenkins, Barclays CEO, has targeted[3] reaching more than 11.5% by 2016. (By way of comparison, ROE at the revered Goldman Sachs just makes double figures, Citigroup only 6.5%, and BNP 7.7%)[4].

> Average ROE at the rich world's Top 10 banks (by market cap) is forecast to reach just over 8% in 2013, down from around 17% in 2005.
> *The Economist*, 14 Sep 2013

Yet all things being equal, if more capital is held as equity, ROE will fall. This is a built-in conflict which regulators will find very hard to disentangle.

Their goal is to set clear, measurable standards for what percentage of its total capital a bank should hold as equity. There are two problems here: how to define equity and capital, and having defined them, how to stop clever bankers finding a way around them.

Slimmer is better

However the definitions are drawn up, it's a sure bet that capital requirements will get ever tighter. Banks react to this in a number of ways. A typical response is to shrink the asset side of the balance sheet.

One symptom? An alleged reluctance to lend to business. Bank apologists grumble that this is predictable: higher equity levels inevitably lead to reduced loan activity. In fact, recent Bank of England figures suggest that in the UK there is no net lending to the private sector at all[5]. And it's a fact that politicians and regulators have yet to square the circle of how they expect shrinking banks to lend more. Here's a hint: they should take a look at how much of bank lending actually goes to customers – meaning businesses and individuals. At Barclays, for example, the figure is 29%. The great majority of its loans are tied up elsewhere[6].

Another way for banks to downsize is to sell off non-core assets. This has the extra benefit of freeing up capital and, with luck, perhaps making a turn on the investment. So, according to a recent McKinsey study, European banks plan to dispose of as many as 725 subsidiary businesses in various sectors and countries.[7]

Taming the traders

There's another aspect to balance sheet management: it's clear that risk officers have been out of their depth in controlling the exotica that trading desks have revelled in. And it's a fair bet that Jamie Dimon had never heard of the "forward-settling ETF positions" that have just cost JP Morgan $920 million in fines – not to mention $6 billion in losses. Or that UBS bosses were familiar with the "credit default swaps on the CDX IG9 index" that lost the bank £1.4 billion in 2011[8].

How far traders can be herded in the direction of prudence is a very moot point. But certainly the regulators will have to tackle the asymmetry that helps traders pocket the profits and leaves the taxpayer to foot the losses.

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[3] *The Independent*, 31 July 2013
[4] *The Economist* 20 July 2013 and 11 May 2013
[5] http://www.bankofengland.co.uk/publications/Documents/other/monetary/trendsjuly13.pdf
[6] *London Review of Books*, 18 July 2013
[7] *McKinsey and Company*, What's next for the re-structuring of Europe's banks?, August 2013
[8] *London Review of Books*, 4 July 2013

Stabilising the P&L

Publicly, banking supervisors focus on balance sheet strength. But privately, they are also concerned that banks generate sustainable profit flows.

On the cost front, many retail bankers are looking at paring expenses by closing marginal branches. But opinion is divided about just how much it's possible to shrink the branch network without jeopardising its role in deposit gathering. Commerz Bank, as one example, has already cut its domestic operation in Germany[9], from 1,500 branches to 1,200. On the other hand, in the US, TD, a remarkably successful gatherer of retail deposits, invests heavily in its branch network.

> Wells Fargo is now the biggest US bank by market capitalisation. As John Stumpf, the chief executive, likes to point out, a Wells branch or ATM is now within two miles of half of America's homes and half of its firms.
> *The Economist*, 14 Sep 2013

Another potential threat to revenue stability is the patchwork of back office systems that many banks struggle with, often following take-overs. The customer service glitches of RBS Group this year bear witness to that.

Leading Spanish banks, however, have an excellent reputation for the efficiency of their manufacturing operations, and it's likely that Lloyds Banking Group picked Santander's António Horta-Osório as CEO precisely because of his background in this unglamorous but vital work. Result? After losing £1.4 billion in 2012, Lloyds is now expected to turn a profit of £2.6 billion this year. Tellingly, its shares now trade above book value for the first time for two years[10].

Enter the dragon

Overall, the logic is that banks will get smaller and fitter. But maybe not for long: once an institution has sold off its so-called "exit quadrant" businesses, sorted out its systems, and written off its non-performing loans, doesn't it then become an attractive target for predators?

Perhaps over the next few years we'll see a two-fold development: sooner rather than later, there will be opportunities for niche operators in, for example, clearing, leasing and securities-servicing, to snap up the non-core businesses that banks sell off. Just in the past few days, for example, NY Life has acquired Dexia's asset management unit.

And maybe it won't be just non-core assets that get consolidated. Consider that Spain had 53 banks and *cajas* in 2009: at the end of last year, it had 12. Today, Italy has more than 700 banks of one sort or another[11]. Alongside that, consider that of the world's top 20 banks, only four are European[12]. We could begin to see some very unfamiliar logos outside European bank branches.

Which means yet another problem for the central banks: how to oversee effectively a large local institution which is managed, and perhaps beneficially holds a great deal of its assets, in another jurisdiction.

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[9] *The Economist*, 27 July 2013
[10] *The Economist* 10 August 2013
[11] *The Economist* 24 August 2013
[12] *McKinsey and Company*, op. cit.

Oh no, not again…..

So much for trying to supervise the future.

But in the present, the mis-selling saga just goes on and on. It's like a horror film cliché: just when the terrified teenagers thought it was all over, another monster comes lurching out of the woodwork. It was perhaps too much to hope that, once the £15 billion PPI debacle was mostly sorted out, we were out of the mis-selling nightmare. Not so fast: here comes another one: card protection insurance.

Covering a mix of card fraud and identity theft, CPI is now adjudged to have to have been yet another boondoggle. Card fraud, of course, is mostly absorbed by issuers, while the risks of identity theft are alleged to have been very much overstated. As a result, CPP, who marketed the product, had to pay out very little indeed in the way of claims. Arguably, their biggest expense was the commission paid to lenders: according to the Financial Conduct Authority, some earned up to 60%[13]. In fairness, there were useful features: one call to contact all issuers in the case of lost or stolen cards, for example. But for the most part, and for most customers, the product was close to valueless.

The outcome: another harrowing appearance for banks in the court of public opinion, more humiliating letters to write, more management time burned up, and another £1.3 billion cost to absorb. Wouldn't it be nice if we didn't have to have regulators to expose this sort of thing?

Now is the winter of our discontent….?

While it's tempting to think that the two themes of strengthening balance sheets and protecting customers are different, it's an interesting link between them that the £5.8 billion rights issue that Barclays has announced – as part of getting to the 3% capital ratio that the FCA has set for mid 2014 – almost exactly matches its £5.5 billion bill for mis-selling.

For all our sakes, we'd like to hope that the banks and their supervisors have a less worrisome winter. But it's very clear that LIBOR isn't finished yet, insider trading and money laundering investigations rumble on, and there are alleged bank improprieties in US energy trading and metals warehousing, not to mention JP Morgan's new difficulties over its sales of mortgage-backed securities.

Looks like more midnight oil will be burned as the nights draw in.

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[13] *Financial Times,* 22 August 2013

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Background

- With more than 20 years of experience in the payment card industry, Roy was previously with American Express, where as VP and General Manager, he launched the highly successful commercial card business in the UK, going on to lead product rollout across EMEA and latterly Latin America/Caribbean.
- As a consultant, Roy works with banking and payment card clients around the world, identifying and advising on best practices in customer marketing and relationship management. He has also undertaken assignments in media, utilities, airlines and retail.
- He has developed and audited coalition and bank loyalty programmes in the UK, Ireland, the Netherlands, Spain, Canada, Dubai, Kuwait, Australia, Singapore, Spain, Israel, Turkey, Saudi Arabia, Brazil, Chile, Venezuela and Mexico.
- Roy has also advised on airline FF programmes, and has been the rewards lead in the MasterCard Advisors pool.
- He speaks fluent Spanish, reasonable French and is the author of *Marketing Planning for Financial Services* (Gower Publishing). He has a B. Com, holds an MA in Management Studies and is a Fellow of the RSA.
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