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THE WORLD TURNED UPSIDE DOWN
Where now for the banks?

At the end of the War of American Independence, the losing British General tried to offer his surrender to the French General Rochambeau. Rochambeau shook his head and pointed instead to George Washington. The action underlined that this was not business as usual – one European power surrendering to another: it was a victory by an upstart. In the background, a military band played The World Turned Upside Down.

Could we equally be at a turning point for the world's banks?

The first thing to say is that, outside the US and Western Europe, many of them came through the financial crisis in pretty good shape. Whether through conservative regulation, as in Canada and Australia, an innately more cautious approach in the boardroom or being buoyed up on a tide of economic and industrial expansion as in much of Asia, a surprising number of banks weathered the storm largely unscathed.

But many of the survivors are having to think very carefully indeed about how far they need to reshape themselves to face the future.

Here's a view from Stephen Hester, CEO of RBS Group in the UK: "We have to accept that the pendulum has swung, that society has a different attitude and determination to make sure that banks behave in a different way and improve their reputation. We have to all deal with the issues from the past and reduce the chance of them recurring. That will take a lot of time and sadly a lot of money as well, in terms of past restitution, I suspect." [1]

Consider the pressures he and his colleagues are facing:

The need to improve balance sheet capital ratios

In October 2012, the IMF commented[2] that, to mitigate their risk exposure, European banks needed to shed $2.8 trillion of assets.

The most visible symptom of this has been the sales of subsidiaries, typically in markets which are now seen as peripheral to the main business. RBS, in fact, presents a timely case

[1] *The Independent,* 26 September 2012
[2] http://www.imf.org/external/pubs/ft/gfsr/index.htm

in point: having failed to sell its Indian offshoot to HSBC, at the end of November it decided to wind the operation down.[3]

Much less visible is the quiet disposal of longer term assets, such as loans associated with infrastructure projects and commercial property. Now seen as a mismatch with the short-term liabilities which European banks in particular have relied upon for funding, Oliver Wyman calculates that these assets amount to as much as €900 billion.[4]

But the need for commercial credit hasn't gone away. Some banks are responding by helping companies on where to find funding, rather than providing it themselves: the argument here is that the advisory fees on for example bond issuance and private placements are just as lucrative as interest income. Others are partnering with institutions such as pension funds and insurers, which have the long term liabilities to match long term assets.

Either way, it seems clear that banks will play a reduced role in providing direct finance for commercial projects with extended gestation periods.

A continuing reliance on Government funding

Apart from the US, where institutions have repaid the vast majority of the Washington-provided TARP funds, the great majority of European governments continue to be heavily involved with the banking sector. Supranational bodies have weighed in, too: since December 2011, the European Central Bank has pumped over €1trillion into support for around 800 banks in the Eurozone.[5]

In the UK, taxpayers still own 85% of RBS and 43% of the combined Lloyds/HBOS banking group. The Government also continues to help out with access to cheap money – the Funding for Lending initiative currently stands at around £60 billion. To begin with, the banks hung on to the cash provided under the programme: the cynics said so as to prop up their balance sheets. But in the last quarter of 2012, the cash at last began to be used for the purpose for which it was intended – retail and commercial loans.

However, an unintended consequence of this Government support was that it has reduced banks' need for retail deposit funding. The result? According to MoneyFacts, fully 40% of savings products now offer less than bank rate – currently a paltry 0.5%. If UK savers, a hard-done-by group, want to beat inflation, the best deals these days are offered by, not the banks, but the supermarkets and retailers' financial services offshoots.

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[3] http://www.globalnews.ca/money/royal+bank+of+scotland+winding+down+indian+unit+after+sale+to+hsbc+falls+through/6442763410/story.html.

[4] *The Economist,* 15 December 2012, p 23

[5] *Financial Times*, 9 January 2013

The threat of ring-fencing

If the taxpayer is to guarantee retail bank deposits, many argue that the quid pro quo is that universal banks should isolate the risky parts of their business; which, being translated, is investment banking. Even as gritty a defender of the universal banking concept as Sandy Weill has come around to this view.

Opponents point out that Lehman Brothers, the failure that precipitated the crisis, didn't operate a retail business, and that one of the most frightening systemic threats came from AIG, not a bank but an insurance company which disastrously decided to dabble in derivatives. Additionally, there are clear overlaps between retail, commercial and investment banking, as when clients are offered products originated by the financial engineers.

Nevertheless, it does seem likely that, in one form or another, regulators around the world will try to find ways of shifting the risk of a bank's failure on to the holders of its shares and bonds, and away from the taxpayer.

> "All history tells us that banks will be at the ring fence like foxes to a chicken coop unless they are incentivised not to do so. On past evidence, they will test it nonstop and try to persuade politicians to alter it in their favour." *Andrew Tyrie, Chairman of the UK Parliamentary Commission on Banking Standards Financial Times, 27 January 2013*

Inevitably, though, the consequence of less risk is less reward.

The temptation of innovation

Mention of investment banking and derivatives brings up the whole question of financial services innovation. A splendid thing in many ways – think internet banking and ATMs – financial innovation also brought us the dreaded CDOs and the whole Pandora's box of "structured asset categories". It seems pretty clear with hindsight that risk managers, let alone the executive suite, had only the faintest understanding of what the wizards in the back room were cooking up, and its potential for damage. It's a sobering thought that, according to the Federation of European Stock Exchanges, on an average day in 2011 there were 6.3 million equity trades of which only 144,000 resulted in stock being delivered to a beneficial owner[6]. (Incidentally, financial transactions tax, anyone?)

For the future, it seems indispensable that senior managers will have to take much greater responsibility for what the bank is creating and selling.

The errors of commission (i)

Consider two figures: 90% and £25 billion.

At its zenith – or should that be nadir? – Payment Protection Insurance (PPI) products were generating seller commissions of over 90%. The eye-watering £13 billion which UK banks

[6] *The Economist,* 15 December 2012, p75

have currently set aside in compensation for mis-selling could nearly double to £25 billion if recent rates for claims payouts continue.[7]

Not least of the consequences of the PPI débâcle for the UK financial services industry is the FSA's recently-announced Retail Distribution Review.[8] Affecting every part of the value chain, from the product originators – banks, insurers, and so on – through to the distributors – banks again, financial advisors and anyone who offers recommendations on savings and investments – the main emphasis is a switch from largely invisible commissions to very visible fees. The effect of this is still not entirely clear: certainly, the goal is to reduce the attractiveness of selling lucrative services which may not be suited to the customer. But in a retail banking context, it wouldn't be too difficult to think up ways to reward branch staff for selling profitable products.

In the new climate, however, one would hope that the spirit, not just the letter, of the regulation is observed. And in that case, there's a real likelihood that retail sales of ancillary products could drop sharply.

The errors of commission (ii)

For years, rumours circulated around the City about how LIBOR was being set. The day of reckoning, though delayed, has eventually arrived.

Fines of $1.5 billion have been levied on UBS – around three times what Barclays had to fork out, because of the "unprecedented" scale of documented fraud. And there's more to come: RBS Group are said to be getting ready for a $500 million hit.[9] But that's only the beginning: around the world, some $300 trillion of products have been sold whose pricing is based on LIBOR.[10] Given that this amounts to around four and a half times global GDP, no wonder the lawyers are fighting to mount compensation claims. The sums involved could make the great tobacco payouts look like chump change.

In another unedifying saga, US authorities have hit seven banks so far with money-laundering fines, ranging from a relatively modest $298 million for Barclays through to an epic $1,921 million for HSBC.[11] Curiously, no US banks have yet been found wanting.

Carelessness – or worse? Impossible to say. But taken together, these two episodes must lead to still more stringent controls over actions at all levels of the bank.

New entrants

When no less an authority than Andy Haldane, the Director of Financial Stability at the Bank of England, reckons that peer to peer lending marks " a time of opportunity knocking for

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[7] http://www.thetimes.co.uk/tto/business/industries/banking/article3649587.ece
[8] http://www.fsa.gov.uk/rdr
[9] *The Economist,* 5 January 2013, p51
[10] http://www.bbc.co.uk/news/business-19199683
[11] *The Economist,* 15 December 2012, p 73

finance", maybe we should take notice .[12] In the UK, Zopa, a 2005 start-up, lent £250 million last year; across the water, Lending Club recently notched up $1 billion of loans, and expects to do $100 million this month.[13] In truth, the amounts involved are still relatively tiny: nevertheless, the rates offered to investors and borrowers are significantly better than the banks', and there is clearly a growing market out there for both sides of the transaction.

Meanwhile, out on the High Street, new players like Metro and longer-established ones like Sainsbury's, Tesco, Virgin and M&S continue to threaten the banks' hegemony in retail financial services: while they have not been able to develop at the speed which some had predicted, there's no doubt that at the very least they provide customers with an alternative to the traditional sources.

Summing up

Addressing the UK Parliamentary Commission on Banking Standards this month, Andrea Orcel, CEO of the UBS investment bank, said that UBS was overhauling its culture and was "serious about putting integrity over profit…. We all got probably too arrogant, too self-convinced that things were correct the way they were – I think the industry has to change," he admitted.[14]

So can Andy Haldane be right when he claims that "The mono-banking culture that has existed since the 1990s is in retreat."? It's probably too early to tell. But one outcome is very likely: banks in the future will be rather smaller, rather safer – and rather less profitable.

According to McKinsey, ROE on investment banking, once 20%, at best will rise to 7%, even after $1 trillion of asset disposals and $15 billion in cost cuts.
Financial Times, 27 January 2013

Postscript - For amusement only: How did William Gibbs McAdoo, one-time Secretary of State to the US Treasury, describe "the banking system"?

[12] *The Independent*, 17 December 2012
[13] *The Economist,* 15 December 2012, p 24
[14] *Financial Times*, 9 January 2013