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TOWARDS A SUSTAINABLE BUSINESS MODEL - HOW FINANCIAL INSTITUTIONS HAVE TO CHANGE TO WIN BACK SOCIETY'S TRUST -

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OVERVIEW

Banking and the extension of credit have always played an important role for the economies and communities it serves. The recent financial crisis not only resulted in staggering losses of around USD 2.3tr but led to a loss of confidence and trust that continues to affect the stability of financial markets, the global economy as a whole and which has sparked public outcry all over the world.

Reconciling the demands of society, investors and the financial sector is one of the big policy challenges we face today. Transforming the financial industry is integral to restoring confidence and trust to those we serve and thereby re-establishing our role in society.

INTRODUCTION

2007 - 2010 saw one of the broadest, deepest and most complex crises since the Great Depression 80 years ago. Originating in the US housing market, it was thought to be a "local" problem, but with the demise of Lehman Brothers in 2008, the contagion spread rapidly across institutions, markets and borders.

Concurrent events led to the crisis but the complexity of it means that its effects are still being felt years on. Loose monetary policy, incomplete regulation, the search for yield, reckless selling of products and the globalization of finance led to a bubble which when it burst sent shock waves of disbelief and instability around the globe.

Today, society and investors demand radical changes from the financial industry. Banks must undergo a transformation and adopt a safer business model in order to regain the trust lost. For some this will be relatively easy, for others a struggle.

HOW DID WE GET THERE?

Facing a recession following the burst of the dot.com bubble and the tragic events of 9/11, the Federal Reserve reduced interest rates from 6% to 1% in 2003. Markets, flooded with cheap money, saw America going on a spending spree and sent house prices on a seemingly ever increasing trajectory. In a bid to offset the risk of inflation, the Fed started to raise interest rates in 2006, triggering the slide in house prices that continues today. The economic implications of this initiated a downward spiral in 2007 with mass defaults on mortgage loans, the collapse of several US mortgage lenders and significant losses on banks' balance sheets. By July 2007, the ramifications of the sub-prime mortgage market collapse began to make its way outside the US, leading to the collapse of the German IKB bank: the contagion had begun. Rapidly, trust between banks evaporated, the interbank market froze, banks' credit spreads widened dramatically and investors dumped financial stocks. But it was not until 12 months later that the crisis came to head with the bankruptcy of Lehman Brothers and reached the "real economy".

Within weeks, governments around the world were injecting vast amounts of capital into banks to prevent their collapse. Within months large economic stimulus packages were approved to support the faltering economy and to combat unemployment. But whilst large amounts of government money helped to stabilize the financial system and the economy, it also triggered investors’ worries about the sustainability of large government debts leading eventually to the sovereign debt crisis in 2010.

THE BANKING INDUSTRY - WHERE TO FROM HERE?

Banks are emerging from the shadow of the crisis, optimistically but tentatively, rebuilding their business, balance sheet and capital. However, regaining the trust of the public and investors is a long way off. Making a safer business model whilst staying profitable is mandatory to re-establish our role in society. So far, regulators are in the lead with demanding much more capital and liquidity. Banks are lagging and not forthcoming about their future business model – this will have to change.

REGULATION: REFORM FROM THE OUTSIDE

Regulatory reforms are the first step to rebuild confidence. Closing gaps in scope and range of supervision, staffing up of regulatory agencies and a set of new rules are all part of the process. The latest iteration of regulatory standards - Basel III and MiFID 2 along with the US Dodd-Frank reforms are the outcome of these efforts.

Basel III strengthens the banks' capital levels and introduces new requirements on liquidity and leverage. MiFID 2 (Markets in Financial Instruments Directive), an EU effort, requests banks to use electronic platforms to clear their derivatives trading (Central Counterparties, CCPs), addresses conflict of interest between sales agents and retail customers and demands "best execution" for all capital market transactions. Dodd-Frank, the US equivalent, combines elements of Basel III and MiFID 2 and also aims to eliminate proprietary trading by banks.

Not fully defined as yet, the proposed changes will have significant impacts around the globe, namely on banks' business models, the competitive landscape, the financial sector infrastructure and the extension of credit.

NEW BUSINESS MODEL REQUIRED

In the future, banks will be asked to hold 6 - 8 times more capital for their trading activities, additionally new liquidity rules will severely constrain maturity transformation. Hence, higher capital and refinancing costs will structurally reduce profitability. The industry will not only face higher costs, it will also have to live with lower margins as a by-product of electronic clearing of trades. Standardisation and price transparency – the unavoidable consequence of electronic clearing - will lead to margin compression as we saw in US equity markets a decade ago.

As a consequence of these reforms, investment banking will become less profitable than traditional banking businesses which encompass retail banking, private banking, transaction and custodian services, asset management and commercial lending.

NEW COMPETITIVE LANDSCAPE

Market liberalisation in the 1980s and 1990s, rapid progress in IT technology and innovation in global communication made it possible for commercial banks such as Citibank, JP Morgan, UBS, Barclays, Credit Suisse and Deutsche Bank to break into investment banking. Today, the sheer amount of capital, technology, infrastructure and specialised staff required forms a formidable barrier of entry. Indeed, during the financial crisis, the big banks have become bigger rather than smaller, and the issue of how to address the "Too big to fail" problem remains unsolved.

However, an often overlooked consequence of new regulations may be the emergence of new competitors. As trading products are standardised and clearing becomes automated, the advantage of old proprietary trading platforms - typically owned by large incumbent banks – will disappear. When counterparty risk is eliminated by CCPs and exchanges offer similar products at a fraction of the incumbent’s costs, good credit ratings hold less value. Exchanges such as EUREX, the European Futures & Traded Options Exchange, or ICAP, a London based interbank broker, or even Citadel, a large hedge fund in Chicago could emerge as new competitors in investment banking.

THE FINANCIAL SECTOR INFRASTRUCTURE

Thanks to new regulation, much progress has been made in upgrading the financial markets infrastructure but there is still a lot of unfinished business:

- Shock absorbers to prevent the transmission of systemic risk need to be bulit

- Market discipline for financial institutions is to be re-established

- Bankruptcy laws have to be adjusted to resolve banks

Mandatory clearing of derivative contracts via CCPs closed one of the transmission mechanisms which spread systemic risk from bank to bank. Unfortunately others remain open. As we learned during the financial crisis, systemic risk also spreads through payment and settlement systems and reaches the real economy via deposits and money markets. Some reforms on deposit insurance schemes have been initiated such as the increase of the insured amount or closing the funding gaps through higher contributions from the financial industry. However, we are still some way off from a real time deposit scheme system that allows bank customers to access their money at any time even when their bank goes into resolution.

Other systemic risk transmission channels such as payments or settlement systems need major overhauls. It is simply unacceptable for society that a failing bank could take down the entire payment system of a nation or even an economic region as it is the case today. Much remains to be done in order to make this part of the financial infrastructure bankruptcy remote and safe.

To allow market discipline to play its role and become a complementary policy tool to supervision again, improving the disclosure of financial institutions is also required. As anybody in financial research knows, analysing banks is rather difficult. Despite annual reports with up to 400 pages abound, the sudden collapse of banks in 2008 surprised even some of the industry’s best analysts. The reforms undertaken so far have been piecemealed and gradual. A fundamental overhaul is necessary.

Last but not least, if banks are ever to be successfully resolved, a special bankruptcy code for financial institutions is necessary. Whilst the resolution of a bank is in principle not much different from the resolution of a corporate – and banks are indeed incorporated! – time is of the essence. A judge has to be able to impose the necessary haircuts on various classes of liabilities over a weekend – if necessary.

THE EXTENSION OF CREDIT

Public and private sector opinions differ sharply about the impact of Basel III on the future availability of credit. When the European Banking Authority (EBA) increased minimal Core Tier 1 capital requirements to 9.0%, during the 2011 European sovereign debt crisis, it was noticeable that the volume of available credit shrank as banks had limited or no access to equity markets. Indeed, the International Institute of Finance (IIF) predicts that credit volume will globally shrink by about -4.8% by 2015 on average due to Basel III. How this works could best be seen in last year's credit squeeze in the Commercial Real Estate market in London. When the German Landesbanks and some French banks pulled out, margins increased sharply, adding significant cost to this part of the UK economy. Implementing counter measures to offset this negative impact of regulatory reform is vital for economic growth in both, the US and Europe.

REFORM FROM THE INSIDE

As regulatory reforms gather pace and start re-shaping the financial industry, banks have remained remarkably silent on how they plan to restore the confidence of the public and society at large.

In a nutshell, banks will have to demonstrate that their future business models are beneficial to society, that they can run their business safely and that they are able to restore profitability to a level which makes them attractive investments again. Given that most banks still traded at market capitalisations well below their book value, this goal is as demanding as the first two.

A SUSTAINABLE BUSINESS MODEL

Over the last three decades up to the financial crisis, investment banking came to dominate the financial industry. Assuming ample liquidity, it was believed that every banking product could eventually be traded. Rapid product innovation supported by low capital requirements in trading books led to attractive margins.

As it turned out, liquidity is not a permanent feature nor are credit products truly liquid. Only a few, such as major currencies, key commodities, some government debt or top stocks enjoy deep and liquid markets.

Investment banking has thus to be refocused on its three core competences:

- Underwriting and distribution of capital market products

- Making markets in tradeable financial products and securities

- Helping investors manage their financial risk.

This renewed focus will also address one of the thorniest issues that has plagued the industry. As we know from IMF research, the USD 2.3tr losses resulting from the crisis were primarily born by institutional and private investors – in other words, from the savings of our citizens for old age and rainy days. All these products have been sold by our industry – something we cannot let happen again. Henceforth, the industry's securitised products need to be simple, transparent and have to come with performance tracking.

Additionally, we have to find solutions to address the imminent drop in available credit. Only banks which are able to meet the credit demands of societies will succeed in rebuilding trust. By actively re-allocating capital from investment banking to the traditional and old-fashioned lending, we will be able to take the sting out of the political debate about the usefulness of the financial industry. Considering the large amount of capital which investment banking will absorb and its future low return on equity, this would also make inherent sense.

RUNNING BANKS SAFELY

As discussed earlier, improved disclosures is vital for the health of the banking industry. But we do not have to wait until the accounting boards devise new disclosure rules. As I know from my own professional experience, it is indeed possible to demonstrate a bank’s performance and risk profile in a few pages. A healthy bank does not have to hide the way it manages liquidity and funding, which businesses make good returns on its capital and which risks could actually topple it. Transparency is healthy and maintains management discipline. It is in my view no accident that banks which are officially rated AA actually trade at credit spreads of a weak BBB name. Markets and investors simply do not trust our disclosures.

There is another point which we need to take seriously. The risk profile of a bank is a function of what our investors are willing to fund and not a unilateral management decision. We therefore must understand the risk appetite of the investors in the different stacks of the capital structure.

For example, Money Market fund managers need assurance that their short term funds can always be repaid and therefore are very interested in liquidity management. Unsecured bond holders want to understand the level and quality of unencumbered assets, buyers of covered bonds the structure and performance of collateral pools and holders of mezzanine debt need information on the thickness of the underlying capital cushion. As a risk manager, dialogue with investors in the various parts of our capital structure was invaluable and helped me move the bank’s risk appetite to a much better footing. Importantly this dialogue engineered a lot of trust.

RE-ESTABLISHING PROFITABILITY

Not only trust in banks has evaporated, their profitability suffered as well. As mentioned before, investment banking is exposed to lower margins and much higher capital charges. Without counter measures, its return on equity will drop below 10%, a range where safe utilities trade. It is thus no surprise that many institutional investors shy away from buying bank shares. Restoring profitability will indeed require some drastic actions. Standardisation of products and process automation will have to replace the tailor-made approach of many trading desks. IT investments in the range of billions will be necessary. The number of people on the trading floors will have to drop to levels currently seen at exchanges. Compensation levels will have to normalise and drop to levels as seen in other services industries such as consultancy, audit, Law firms or in information technology. Capital intensive inventory for securitisation will have to return to its originators. Market making will have to be re-thought and possibly move back to exchanges where it was done before broker-dealers assumed this function. Also, the back-offices of banks will have to learn from lean production and run along the principles now applied in modern manufacturing.

Such changes will differ from bank to bank but eventually translate to a process revolution as we have seen in retail banking in the early 1990s when a rather bureaucratic way of doing business was transformed into a dynamic, high tech and consumer friendly business model.

CONCLUSION

New regulations, changing behaviour of investors and a much more demanding public opinion are already changing the world of finance. But we have not heard enough from the financial industry on what it can do to make banking both safe and useful and restore its profitability again. Society needs a banking system that is able to extend credit and absorb the related risk.

Only by actively designing and implementing a new business model that delivers sustainable risk rewards in a transparent fashion, the financial industry will be able to regain acceptance. It is time to deliver.

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