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GLOBAL riskupdate

The quarterly independent risk review for banks and financial institutions worldwide

2017 Economic Predictions

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The Threat to Banks

Viewpoint from the Editor of Global Risk Update.

News flash: Banks are evil and full of evil people. They need to be punished and we need to make sure that the problems of the past never recur. The past in this case is the crisis of 2007 where so-called 'casino bankers' nearly caused the collapse of capitalist society.

That this crisis is so little understood and had more to do with misguided, but well intentioned, regulation has been well documented. The problem is that by misunderstanding the causes of the problem then the solutions implemented are unlikely to be worthwhile.

So what are the some of the threats to banking? And how will banks survive?

(1) Banking Regulation

Banking regulation are not guardians of banks or the banking system. Regulators are essentially unelected officials with enormous power, often from central banks, mainly political appointees, who set the rules. In the USA at least 50% of banking supervision heads at state level are individuals with law degrees with little financial services experience.

What are the success criteria for regulators? They are judged as successful if banks under their jurisdiction do not fail as a consequence of the actions that they have taken. Whether this is good for the global economy or society is actually not their concern. They essentially have a single goal to ensure that if a single institution fails that no other institution will fail. That this makes very little sense is not currently an issue addressed by industry or society through social media.

(2) Customer Expectations

Recently banks had numerous branches to show that they were a big bank. Lots of branches suggested success.

Customers went into branches to deposit funds, arrange loans and make payments. These days have gone forever. Now there are very few reasons to go to a bank and even if you do retail customers are increasingly confronted with a machine and a person to explain how the machine works.

Most retail customers do not want to visit the branch unless they have to. Corporate bankers come to their customers.

Payments are being made electronically, and do the banks really want deposits? We will come to this again later.

As customers increasingly resort to on-line services there is a change in customer loyalty. Many of you will still retain your first bank account. In future this will not be the case and customers will increasingly be receptive to marketing approaches from new businesses. If retail customers are doing their banking on-line then they expect it to be relatively cheap, so the banks' ability to charge is reduced.

As customers expect more for less their profitability to the bank is significantly reduced. Activity based costing, which is essentially recommended by the new regulation, becomes a must for banks. They need to identify which products that they sell are profitable and indeed which customers remain profitable. It is perhaps a sad fact that customers that visit the branches are rarely profitable; indeed they are often the customers that have not fully embraced the opportunities that internet and mobile technology provides.

This poses society with a problem. As retail bank branches close many towns will not have any branches at all leaving customers who do require those branch services - including the elderly and disabled - disenfranchised. But can banks really be expected to continue to provide loss-making services?

The dilemma is that society's general view is that banks are bad and need to be punished, not that they provide essential services to communities.

(3) Changing Competition

The role of the bank used to be to cycle money within the financial system. They took in deposits from the public and used these funds to provide facilities to other parties. Housing loans, which we will come to later, were at the heart of this activity. The income of the bank was generally related to their ability to raise a decent margin over their cost of funds (the deposits) in the rate that they charge to their customers.

The best bank customers were never particularly profitable. They were able to always get preferential rates and lower charges than less well-off customers. Banks make their money from charging relatively higher rates to customers who have limited ability to go anywhere else. The better rated customer can go anywhere whereas the lower rated customer is often stuck with the bank it is with.
In the 1970s the maintenance of an extensive branch network was both expensive and formed a barrier to new entrants. Now that so much banking is undertaken on the internet these barriers have essentially gone and it is easier for parts of the business to be eroded. Of course it is deposit taking that determines a firm is licensed as a bank. Many institutions that lent money were never banks, indeed anyone lending out their own money did not require a banking license, although another form of registration might be required. The new market lending entrants will not particularly want to be deposit takers, they will just want a low cost of funding.

New lending firms want to take the profitable business that traditionally has been undertaken by the banks, which is lending to what might be termed second and third quartile customers. Peer to peer lending is one such opportunity but it is not alone. Increasingly as deposit rates are low or lag inflation companies with funds are seeking ways of achieving a return. They will do this in part by essentially banking their supply chain. The benefits of certainty that this provides them with and the increased return that they receive makes this all worthwhile and the regulatory arbitrage that is biased against the banks makes it profitable.

So banks have customers that are less loyal and expect more for less while at the same time new entrants are arriving to take their customers..

(4) The Changing Regulations

For banks it does not matter where you turn, the regulations are changing dramatically. (And not just banks: other parts of the financial services industry are also being hit by these changes with MiFID, MAD, AIFMD and EMIR being just a few of the changes coming through.)
The impact of Basel 3 (or Dodd-Frank for the USA) on banking has been draconian.

We see that there is a significant misunderstanding which is at the heart of this new regulation.

The regulators are wedded to the idea that banks need ever increasing levels of capital and liquidity sufficient to ensure that were they to fail that no other firm would be critically damaged, what is referred to as contagion. They need to have sufficient capital and liquidity to deal with extreme stress, events that are extremely unlikely to occur.

Maintaining excessive capital and liquidity is expensive. The returns on these assets is poor and essentially they cannot really be used. Do you remember the idea of insurance was that the losses of the few were picked up by the many? This simple opportunity for risk sharing is now lost forever in the banking industry.

Each bank needs to keep its own capital and liquidity sufficient to address a stress event which is unlikely to occur.

This is manifestly inefficient. By causing banks to tie up excessive capital and liquidity the regulators are both removing these assets from the money supply and making it more expensive for the banks to lend out their funds. This then impacts the economy at large restricting the funds available while increasing their price. This plays into the hands of the new entrants who may not have all of these requirements to comply with.

Current banking regulation actually hurts society, increases unemployment and reduces economic growth. Clearly the level of capital and liquidity that a bank maintains should be sufficient for the day to day running of the bank and to cover moderate stress. In the past extreme stress was addressed by the lender of last resort, the Central Bank, but that is no longer the case. With the Central Banks no longer fulfilling that role, and no replacement mechanism created for all the banks to pay into, the regulators have enforced a regime on all the banks which ensures that they are unable to meet the key obligations of their lending and cycling role.

(5) Central Counterparties

Amongst the biggest mistakes that regulators have made is the dislocation of the derivatives.
Why has this happened?

The financial crisis was misunderstood, thought to be caused by weaknesses in the regulation and transparency of derivatives so something had to be done. But was it? The so-called derivatives that perhaps were at the heart of the problem were what are termed securitised assets. An important asset class these are a pool of facilities, such as housing loans, which are packaged and turned into bonds. Interestingly the regulations governing these assets have barely changed since the rules were there already although not enforced.

New regulation was the answer, but what was the problem?

The decision was taken to move as much of the derivatives market to central counterparties as possible. Either the instrument should be conducted on an exchange with daily mark to market margin or the margin should be posted to such an exchange. This is now in place and has increased the risk that it was intended to reduce.

In the past such transactions were conducted on the basis of robust legal documentation developed by the International Swap Dealers Association (ISDA). Such instruments actually assisted during the crisis in transferring risk throughout the system. They were not the cause of the crisis, rather they were the solution. In the new environment with margin being placed their liquidity has disappeared. Bid offer spreads have widened. Risk is now concentrated in central counterparties which are applying margin rules which are actually lower than the risk requirements of firms. They are not providing these bodies with sufficient assets to withstand extreme stress since the level of margin that would be required would result in disappearance of all such instruments. This actually means that far from reducing the level of global risk, the risk has actually increased. We believe that the next crisis is likely to be caused by a failure of a central counterparty and the derivatives market will not be able to help.

(6) Interest rates

There also appears to be a lot of confusion regarding the purpose and impact of interest rates. Interest rates have become artificially low due to government action. At such rates the banks find it harder to make a profit. Increasing rates provides banks with the ability to raise rates on floating rate loans, but of course not fixed rate loans which are the cornerstone of the US economy.

It is always important to remember that floating rate notes and bonds do not float; rather they step in arrears based on a reference value. They do not float due to an increase in capital or liquidity requirements unless this is specified in the customer agreement.

The pressure is to increase interest rates in the US and with regret the rest of the world will follow. We have a higher level of government borrowing globally than has ever been the case before. Indeed the numbers are staggering. The problem with raising interest rates is that at some stage the investors recognise that fixed rate bonds are poor value unless their value is anchored by a relatively short redemption period. The idea of trying to fund the US economy based upon three-, six- and nine-month bonds is really rather challenging. As interest rates rise the expectation is that sovereigns and municipals will default causing all sorts of problems.

That the regulations that the banks have to comply with are designed for a market where interest rates are declining is only part of the problem.

We are entering a difficult part of the economic cycle with globally leverage at heightened levels.

Bringing it together

So banks will need to deal with the cost of regulation, higher capital and liquidity, greater competition and a market which is not conducive to being profitable. None of this is easy. With IFRS 9 now requiring even more provisions for the banks perhaps we have reached the point where banks will start to wonder if their business model still works.

As a continuing trend we expect many more banks to merge since the next crisis rather than being a 'too big to fail' crisis will actually be a 'too small to succeed' crisis. Banks need to become much more efficient and be clear how they will make money in this new environment which is likely to last for the coming 20 years.

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