

Over-regulation of the banking sector will choke off the recovery

By Bob Lyddon, Managing Director, IBOS Banking Association

Official responses to the crisis in global banking point to more focussed and localised banks, pursuing a narrower range of activities, at a time when corporates are cash-rich and looking to exploit global sourcing and selling opportunities. How will corporates then access banking services? And what types of banks and bank collaborations will result if, as seems inevitable, the European Commission's drive to foster pan-European banks with globally competitive scale comes to nothing?

The IMF has proposed a Stability Tax and an Activity Tax – to dissuade banks from “risky” activities and to set up a reserve fund to support banks, as an alternative to direct taxpayer support.

Michael Barnier, the EU's Financial Services Commissioner said on 2nd June 2010 that European banks may face taxes on the size of their balance sheets, on how much they owe other institutions or on how much profit they make. The cash so raised would be used to pay for future bail-outs.

The Bank for International Settlements has Basel III on the stocks, causing banks to hold more capital against a given type of risk than they did under Basel II, in order to increase bank stability.

New Liquidity Rules would compel banks to hold larger percentages of short-term deposits in low- or no-interest deposits with Central Banks (or in the form of government bonds).

This is at a time when a study of 58 major banks by Independent Credit View, a Swiss rating company, concluded that banks may have a capital deficit of more than \$1.5 trillion by the end of next year, taking into account a rising regulatory capital ratio – at a time when capital markets are unreceptive to new issues and existing shareholders cannot be relied upon to take up new issues that represent “massive dilution”

The toothpaste tube is to be squeezed in too many places:

- rising regulatory capital ratios = less business volume on the same capital
- rising liquidity reserve ratio = lower profits, if the costs cannot be passed on to depositors
- demand for funds to create a stabilization fund
- extra tax on profits
- special charges if the banks are active in certain lines of business
- demand to sustain lending levels in the home country as the price of government support (e.g. Lloyds TSB in the UK)
- pressure to sell off lines of business that may be seen as non-core as the price exacted, for example, by the EU, for a specific bank having received government support (e.g. RBS being “encouraged” to sell its Direct Line and Churchill insurance businesses)

Taken all together, the results for the banking industry are a reversion to so-called “home markets”. This is a key phrase and has been used in several major consultancy projects where McKinseys have advised banks.

The “home market” may be a territorial one, a country, or an activity, or both in combination. The phrase popped up in relation to HSBC CEO Geoghegan relocating to Hong Kong — “the bank's old home”.

Barclays has, in 2010, announced a review of its overseas retail banking operations to establish which ones can become Top 10 players in their country, and which cannot. The phrase “Top 10” is surrogate for the notion of having a major footprint and a sustainable, balanced business with reasonable market share in key lines of business (which, in retail banking, would be current accounts, overdrafts, mortgages, debit and credit cards and so on). Depending upon the size of the country and number of bankable clients, Top 10 may not be sufficient. Closure is an option that has not been discounted for those which cannot make it over the bar. In this context phrases like “find new ownership” and “refocus” are commonplace.

Certain banks have already had a sustainable business model for some time. One can look to banks like Nordea and KBC, each of whom have a model with multiple “home markets” and in each of which the bank has a major footprint and market share across a range of business lines. All of the merger partners in Nordea were already major banks in Finland, Denmark, Norway and Sweden respectively. KBC of Belgium acquired leading banks in each of five C&EE countries: Poland (Kredybank), Czech Republic (CSOB), Slovakia (CSOB Slovakia), Hungary (K+H Bank) and Bulgaria (CIBank).

More common, however, is the structure of a network of small operations in a number of countries, with each operation being in the respective country’s financial centre, and focusing on wholesale banking. That would often include activities regarded as “risky” under the new regime: those activities could easily be the jewel in the crown of the operation, the Unique Sales proposition for local corporate and institutional customers to deal with that bank there.

For example, in earlier eras the USP of Lloyds Bank International, Amsterdam branch, towards Dutch corporate clients was its ability to take medium-term country risk under export credit loans paying for the construction of dry docks in Nigeria by a Dutch harbourworks contractor, or a gas pipeline in Argentina being constructed by a Dutch engineering company. The USP of Manufacturers Hanover Trust, Frankfurt, towards German corporates was DEM swaps, caps and floors before the German banks became active, and for Landesbanks it was an ability to source Yen private placements in Japan and swap them into LIBOR-based funds in DEM or USD.

In every case the bank had a temporary monopoly over the USP, which then evaporated – due to the first sovereign debt crisis (in 1983, when it was initially Mexico that defaulted on its debts in foreign currency), due to competition, due to investor funds drying up and due to an interest rate configuration (e.g. Japanese Long-Term Prime Rate being moved by the authorities relative to US Treasuries).

The nature of international banking through branch networks is inherently one of opportunism, temporary monopolies and rather fragile USPs. These “risky” businesses such as venture capital and proprietary trading may come to be seen as another phase. What always remains, though, is a cost base (including cost of compliance with regulation) and residual liabilities (e.g. employee social costs).

Only a few banks with very centralized technology and operations (such as Bank of America) have succeeded in rationalizing the costs at a sustainable level.

Should tax or regulation eliminate these “risky” businesses as a source of local revenue and sharer of costs, the cost allocations onto the other business lines will rise, making the entire operation marginal. Therefore it will be easy for banks to justify complete closure of these marginal operations.

Against this background the EU’s policy between 1990 and 2008 – which was aimed at fostering the establishment of strong Pan-European banks, able to have the scale to be cost-competitive on a global level – goes into reverse gear. Initiatives like SEPA, MiFiD etc., to create a single internal market in financial services, are undone by the insistence of individual member states on a “home markets” focus from the banks they have supported.

The result is no banks who are both full service and global (or even Pan-European).

On the other hand, corporates have continued to globalise during the financial crisis, they are well-funded and leaner, and ready to exploit any economic upturn. How, though, will they access the required banking services?

A German or French corporate may no longer be able to rely on being serviced by overseas banks through Relationship Managers based in the bank’s branch in Frankfurt or Paris, or indeed even London, if “Foreign Multinational” as a customer set is not seen as a customer set relevant to the “home market”. Relationship Management might then only be offered where the bank is, not where the customer is, including support in fulfilling KYC requirements to get an account in the first place, and support for electronic banking.

This is effectively a return to the banking of the 1980s, with a corporate requiring international banking services having to deal with a patchwork of relationships, and having to travel to the banks to get their business done,

without the benefit of having a 'traffic cop' in the form of a Relationship Manager to help them navigate through what will be a large and diverse bank in that "home market".

In the 1980s, international banking services were only required by a small subset of companies, that is services going beyond international payments and collections, L/Cs and Collections – because these companies did not trade globally. That is because such a relatively small number of countries were "open for business". The Soviet block countries and their satellites in Africa and Asia were substantially closed, as were many countries in the Americas. Now a preponderance of countries are open.

Similarly communications, logistics, the internet etc. have permitted companies to have a global business model from shortly after foundation, rather than going through the stages of establishment of a domestic market, foreign agents, foreign subsidiaries and so on. Technology and bio-tech companies, as an example, want to exploit their intellectual property on a global basis from early in their own lifecycle, when they may be only a single patent company.

Under the old model they might eventually establish a foreign subsidiary, hire indigenous managers who knew their way around the banking system and could establish banking connections for the subsidiary – and for the parent.

In the new world there is no subsidiary, no indigenous personnel – how then is a banking connection to be arranged? Depending upon the company's business sector, a basic service as available at a foreign bank may not be good enough, assuming that is that there even is a branch of a foreign bank in that country which would see the subsidiary and the parent as part of its target market and upon whom they are willing and capable of carrying out AML checks.

AML requirements now include checks on beneficial owners where the ownership exceeds a certain level (normally within the range of 10-20%). How does AML get carried out by a French bank on a company which has a 15% owner in the USA and a 15% owner in Canada? That is "how does it get carried out in less than 6 months?". Normally the French bank would have asked its New York and Toronto branches to handle the AML checks, but if, in future, there is no Toronto branch at all and if the New York branch regards this work as outside its scope, the business may not get done.

This is a challenge for corporates, and of course for banks, but it should also be a reality check on all the politicians and regulators who want this focus on "home markets", who want sustained lending at historic levels, and a stability fund, and better capitalisation and liquidity and so on, but whose "home markets" are part of a series of global supply chains. Businesses in those countries increasingly need global banking services and both a human channel to learn about them and select them, and an electronic channel to access them.

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