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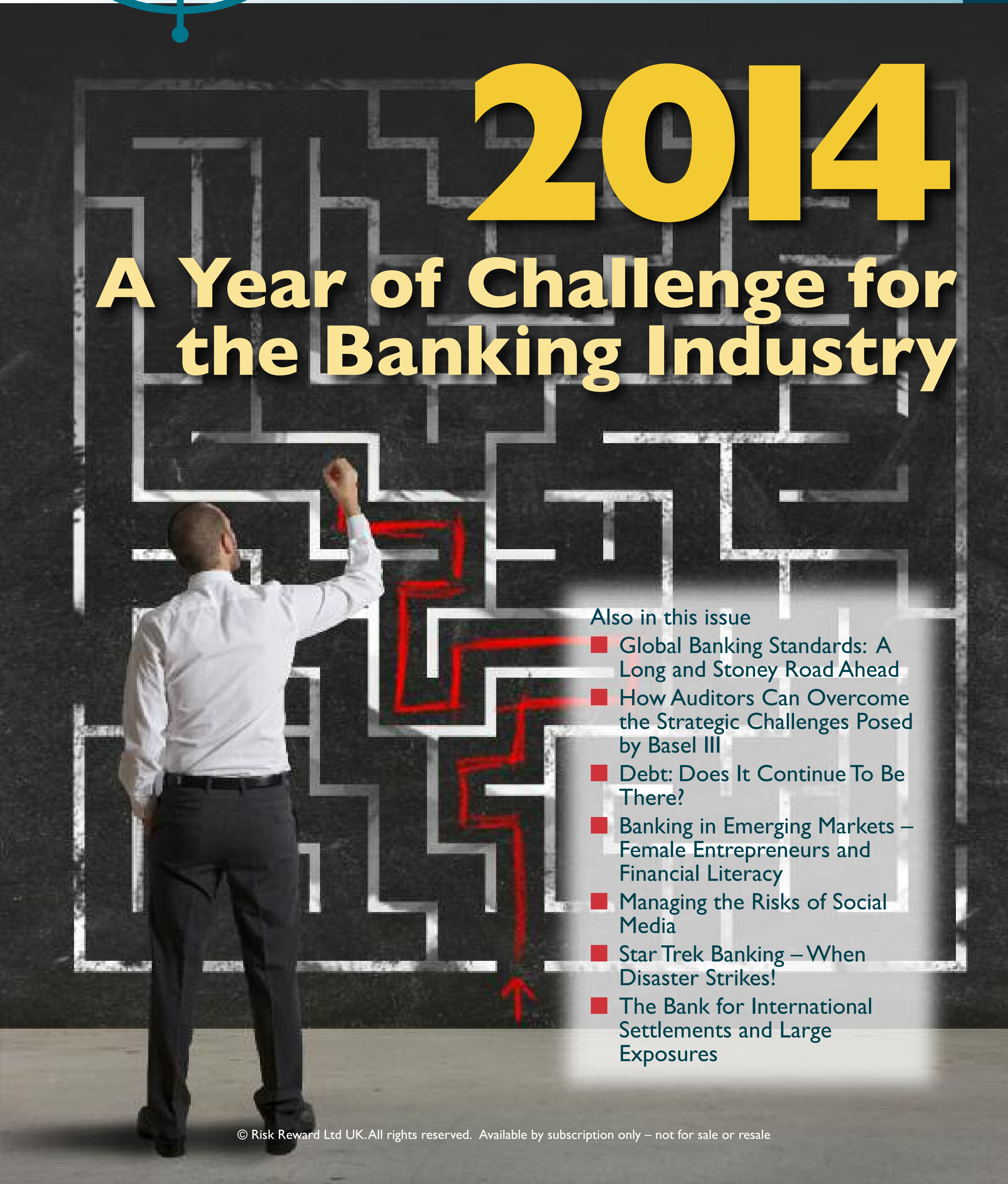

2014

A Year of Challenge for the Banking Industry

Also in this issue

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Global Risk Update Editor in-Chief Dennis Cox looks at some of the key issues that need to be faced and the likely direction of change both to the banking industry but also to the investment landscape.

There are a number of major changes currently occurring in the banking industry and this is creating both challenges and opportunities for the banks. In practice this will mean major change for many forms as they seek their role in the new banking industry paradigm. They will need to evolve into more cost effective and efficient organisations which add value to society, but there are many problems. In this article I look at some of the key issues that need to be faced and the likely direction of change both to the banking industry but also to the investment landscape.

The Structure and Business of Banking

Over the last 30 years we have grown used to the idea of ever larger banks undertaking a wide range of roles within both the commercial and retail business space. Many had grown into major institutions with a global footprint. These days are essentially over. As the rules developed in the light of the crisis are sporadically implemented inconsistently by regulators, firms need to consider where they need to do business and why.

In future as the Basel 3 and other regulations are increasingly implemented, it will be harder for banks to identify and undertake profitable business. The costs associated with the increased capital and liquidity required as well as the changing industry will all have a significant impact. Banks will need to look at each of the businesses they undertake and properly assess the profitability of activities undertaken including the likely costs of capital that will apply over the life of the product.

Since many banks do not have adequate activity based costing systems they are unable to properly understand the costs associated with the business that they are doing. This could mean that products are essentially being mispriced. In reality, pricing applied by banks does not always follow what might be termed normal accounting principles commencing with costs and adding margin to arise at a price. Instead the market price for such services is often driven by competitors all chasing the same business with many of them essentially selling their products with an inadequate expectation of return.

Of course as we shall discuss later the uncertainty of the regulation being applied does make it even harder to set an accurate price over the product life time.

The consequence of this will be that banks will focus on niche activities where they are able to make an adequate return. The consequence for customers will clearly be increased costs and reduced competition between banks. However non banks will increasingly be seen, as the normal way to deal with many issues traditionally left to the banks and this will lead to profound change. Whether Boards of banks recognise fully the speed and impact of this dynamic will be illustrated by their ability to fully grasp the opportunities which come with these challenges.

The Impact of New Non Traditional Entrants to the Market

It is clear that regulators are concerned about two main issues. The first is that the failure of a bank could cause losses to taxpayers. The second is that personal deposits could be lost. They do not appear to have the same level of concern over wholesale,

commercial or larger deposits, but smaller deposits do give a cause for concern to regulators. In protecting these assets the regulators are designing a regulatory regime that ensures that each bank has sufficient liquidity and capital to meet extreme circumstances. This approach has little to recommend it and would be akin to everyone having sufficient funds to deal with anything that they might insure. If you consider that you needed £500k of insurance cover than you would have to have the ability to get £500k in liquid assets. Essentially the insured becomes the insurer.

What these rules cause is a lack of growth in the global economy. The price that is now required to render the business profitable becomes inappropriate to the customer. Business overdraft rates of 9% above base now become commonplace but are clearly inappropriate to the needs of the market.

If a firm does not take deposits then it does not need a banking license and will not be captured by the Basel 3 regime. There may of course be some level of local capital requirements but they are unlikely to be of such significance. Consequently such firms are at a competitive advantage. Where are these funds? They are held by companies and other non-financial institutions. What we will increasingly see if new entrants that are not deposit taking institutions entering the market place and taking significant market shares. The growth of crowd funding in all of its guises is also a game changer. If you run a small business then crowd funding is likely to be able to provide you with a type of funding at a price and with a speed that banks are unable to match.

The consequence of this will be that banks will need to think carefully about what their role is likely to be in the future with much of the business that they currently undertake becoming unprofitable and also declining in market share. Free services will clearly need to become a thing of the past and many branches will close.

The Impact of Dodd-Frank

However there are other major changes afoot which have different impacts. In the US the implementation of Dodd-Frank has resulted in non-US firms needing to consider what business they are booking into the US. It will no longer be appropriate for such firms to use their US office as a booking centre for non-US domiciled activity and this will increasingly be repatriated to their home market. The only real alternative is to either purchase a US bank with a large capital base or reduce the level of activity conducted in the US.

What we are expecting is that the foreign firms operating in the US will really start to question both the activity conducted and the size of the assets maintained in the US. This is of course likely to be to the detriment of US banking since; once the business is reduced to the rump US activity the remaining business is unlikely to be profitable. We would expect even major overseas banks to exit the US market and the majority to significantly curtail their US business.

The disappearance of so many firms from actively operating in the US market will again remove competition in key international banking sectors with a consequent increase in pricing for US customers. Again the effect will be experienced by the real business community and well intentioned regulation will have an impact that does not appear to have been fully considered.

The Change in the UK

The regulatory changes in the UK are also significant for some foreign banks operating in the UK, although the challenge is perhaps easier to overcome. The pressure is on for many of the overseas banks that currently operate purely through branches to convert their businesses into full subsidiaries. This will mean that the new organisation will be subject to the same liquidity and capital adequacy requirements as other banks operating in the UK.

If you are currently operating through a branch in the UK then the change of structure to a subsidiary is of course possible. The new firm will need to be separately incorporated and capitalised meeting the new capital and liquidity rules. New governance structures will be required including suitable non-executive directors, audit and remuneration committees. New reporting routines will need to be implemented together with ICAAP reporting. Of course the bank could choose to not deal directly with UK retail customers and may then be able to continue to operate as a branch but in many cases the remaining business alone may not be sustainable.

Another challenge will be to move the assets, liabilities and contracts to the new business and then to implement the revised compliance regime effectively. All of this will incur significant costs and we would suggest that may not be appropriate for all financial institutions.

The Change in Investment Banking

We are clearly seeing the end of the historic investment banking growth trend that operated until 2008. In 2014 there is some increase in IPO activity and we do expect that to continue throughout 2014 and into 2015. This is driven by a number of factors including pent up demand slowly being realised. There clearly are a lot of liquid assets available chasing suitable investment opportunities and with interest rates at historic lows equity investment remains one of the more interesting areas to consider.

Why then are investment banks becoming an endangered species? The fallout from the recent (or continuing) financial crisis places much of the blame on investment banks and this is clearly demonstrated by the size of the penalties that have been sought. This has bought home to Board directors and regulators the true level of risk that clearly exists in such activities.

Regulators and politicians will no longer accept the risk posed by an investment bank which is either attached to a retail deposit book or potentially poses a risk to tax payers. The only way to ensure that no such losses occur is to significantly reduce the level of risk inside the investment bank and that means a restriction on the activities conducted. In the US we see this through the Volcker rule inside Dodd-Frank essentially prohibiting proprietary trading whilst trying to maintain market making.

The investment banks used such trading activities to generate their profits while at the same time creating market liquidity. If the proprietary trading activities are removed the investment banks retain a rump business of trade execution, market making and long term fund creation. All worthy but, not as potentially profitable as the previous business. What we are seeing is the investment banks significantly reducing their activity with independent firms such as our subsidiary Niven Capital Limited increasingly being asked to design structures which historically would have been the exclusive domain of the investment bank.

We see this trend continuing into 2015 with a smaller number of investment banks chasing a smaller pool of opportunity with greater transparency, high costs and lower returns and non banks increasingly becoming involved in such activity.

Change in Retail Banking

Why do we still have so many High Street branches? What is really done there? When did you last visit a bank branch? Did the bank make any money from the transaction you undertook? One of the consequences of the banks needing to work harder to ensure that they are able to earn an adequate return is that areas such as branch banking come under threat.

The changing ways of working means that many transactions that would previously have been conducted in a branch will be conducted on-line or by phone. This trend is due to accelerate in 2014 – 2017 resulting in major change for the High Street. In a typical town you might have seven or eight bank branches. By 2017 this will have reduced to no more than one or two and in many cases to none. Countries such as Kenya have already made this change with in excess of 75% of payments now being made by phone in that country.

The banks will also be squeezed on their income. If an SME or individual previously wanted to raise funds their first and perhaps only option would have been to go to the bank. Larger firms can of course issue bonds and equity, but for the smaller firm this was not and still is not a realistic option. Accordingly the bank was the place to go to for loans and overdrafts, but that is no longer the case. Crowd funding has come out of the shadows and is increasingly becoming mainstream. With platforms such as Funding Circle having already provided almost a quarter of a billion GBP of loans they and a series of other new entrants will become the natural home of retail and SME funding. The change is starting and we would expect this to accelerate in the next five years. With banking overdraft rates at between 5% and 10% above base, there is plenty of opportunity for more nimble service providers to take significant market share.

However the capital advantages that the crowd funding industry currently enjoys over the banking industry will in our opinion increasingly be under threat. We do expect increasing capital requirements to be placed on crowd funding platforms even if intellectually this makes very limited sense and will again try to prevent them from serving the community effectively.

With the challenge of a loss of a reason to exist in the High Street combined with the loss of key revenue, the trend for reduction of bank size is likely to occur faster than you might expect. In some cases radical solutions will need to be considered with famous names disappearing.

Change in the Derivatives Market

In previous articles we have expressed our concerns over the creation of a central counterparty with the increase in systemic risk that is self evident. That such central counterparties have effectively been designed using the model of the futures market with confidence levels of margin being insufficient to deal with a stress event only serves to illustrate the erroneous thinking which has led us to what may prove to be the next but one disaster.

As you increase the costs of an activity the commercial imperatives change and we are seeing that with derivatives. There are almost no commercial transactions that need to go to a central counterparty that could not have been better structured a different way such that they are not eligible to go to an exchange. Accordingly the reduction in derivative activity in the US market caused by the creation of the central counterparty which is believed to be around 80% has profound implications. For the banks another income stream has been severely curtailed.

Since the banks do not choose to sell the alternative structures which would serve the market better, corporations that formerly were hedging risk will cease to do so. At its most basic the costs of hedging will be so high that the commercial decision will be to let the risk run. Of course this serves only to move the risk from Wall Street to Main Street and renders corporations less secure. So what is bad for the banks is also bad for business. But worse we will see reduced liquidity in instruments and increasing bid offer spreads as a consequence o the erroneous decision. If we needed greater transparency this could be achieved simply by adding a reporting suite to the current SWIFT based ISDA interpreted confirmation process. That would have been cheap and effective. What we have is an expensive solution that most firms will not want to use that creates systemic risk rather than the former distributed and collateralised credit risk.

We are concerned that central counterparties might fail through a combination of unsustainable costs, low volumes and the eventual realisation that it did not need to be like this.

The Investment Market

We do not expect interest rates to rise in the US or UK this year and question the likelihood that they will rise in Q1 2015. We continue to be negative fixed income securities with a residual tenor greater than a year and will probably hold that position for the next twenty years. We are also

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negative gold in the short term and remain concerned that the Chinese growth story is essentially over for at least the next five years.

Are we in a recovery? It is hard to say. If this is a recovery it is clearly at best fragile. But there are asset bubbles being created. In many countries of the world we are seeing evidence that housing bubbles are being created. We do not agree with the concept that housing bubbles create wealth since they generally create poverty and unrest. Of course Basel 3 requires the implementation of countercyclical capital to counteract such bubbles although we doubt that these are likely to be called.

Another bubble is clearly occurring in investment prices being paid for firms that are at valuations which are clearly inflated. If a firm is being sold at 150 times profit something is really badly wrong and with regret there will be another stock market crash caused by the realisation that such firms are massively over valued. However since commodities and bonds are likely to remain depressed this crash will probably not take place until Q3 2015.

So for 2014 we believe that equities and property will perform well, with commodities and fixed income performing poorly.

All in all a difficult scenario for the banks to face, but face it they must. What you can be sure of is that there will be significantly more badly designed and ill thought through regulation which is technically suitable but practically a disaster.

The Commodities Market

We remain cautious regarding commodities generally and assets such as gold and oil particularly. However this is predicated in a global macro political environment which at best might be described as heightened. Looking at each of the main commodities:

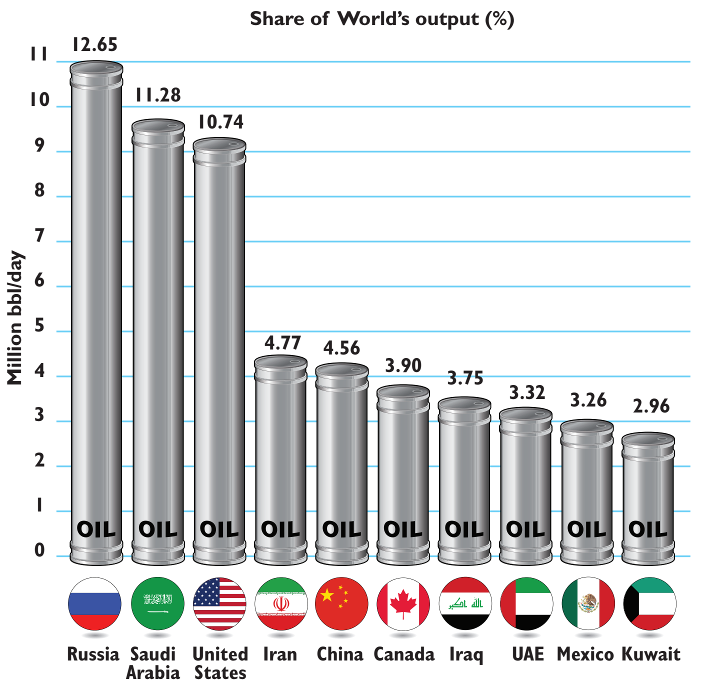
1. Gold

As we have discussed before gold is actually not a very useful metal although it has perceived value. It has very limited commercial uses and to believe there will be a significant rise then you need to believe there will be growth in India and China. We are far from convinced that there is a major growth story in either market and accordingly anticipate that the market will remain subdued for the next three years. For 2014 we remain negative.

2. Oil and Gas

The geopolitical issues surrounding oil have been rehearsed in many articles, although perhaps the level of focus is changing. The growth of non-OPEC oil deliveries is also making a major difference. The most recent summary of exports is shown in the chart:

List of Top 10 Largest Oil Producers in the World 2013



- See more at: http://www.whichcountry.co/top-10-largest-oil-producing-countries-in-the-world/#sthash.n2GiknyW.dpuf

Some of the names here may surprise you, although these are the gross figures, not the net figures. Indeed it is anticipated that the US could overtake Saudi Arabia and even possibly Russia by 2017.

Of these countries Iran and Iraq are hardly producing at full capacity and questions exist over the level of investment in the Russian oil fields. Of the producers that are not on this list and could produce significant oil Libya and Nigeria are of clear interest. Looking at the list suggests significant disruption to a major source of supply becomes increasingly unlikely due to the global producer spread. With the price differential between gas and oil being at a historic high the expectation is that oil prices will remain constrained during 2014.

We do not expect there to be sufficient global economic growth to create the dual effect impact of an increase in the oil price and the gas price in the next three years. So on balance we remain negative oil and neutral gas.

3. Fixed Income and interest rates

Why does anyone still buy long dated fixed income paper? Given the yield curve in all major markets there is an expectation that such assets will decline on a mark to mark basis over the coming years. We do not expect a growth market in long dated fixed income securities for at least ten years and perhaps even longer.

The only real market is likely to be in assets where the redemption value provides an anchor to dissipate the effects of rising interest rates. As to the question of when rates will rise, trying to second guess politicians is always a high risk activity. However we cannot see any real reason for interest rates to rise in 2014, but do expect rates to rise at some time during 2015/2016. The ability of Central Banks and politicians to be wedded to policies that lead to low interest rates and potentially stagnation has again been written about many times. We will not revisit that here.

4. Food Stuffs

One of the more pleasing scenarios has been the decline in price of certain staple commodities. The 12.5% reduction in the wheat price since October 2013 is of course good for the global market if not for farmers. There has been a similar story with rice, for example, where there has been a 14.2% decline since August 2013. For everything that climate change has thrown at us to date there has not been a consequent increase in staple food prices generally. Again the limited growth in the global economy will not be pushing consumption and the China story could be a break on growth for a significant period to come. On balance we are neutral commodities.

5. Property

We are concerned at the growth in UK and US property prices. Once property markets are growing at 10% or more this is leading to the expectation of a bubble. Of course you will be thinking that the price recovery is both uneven and from a lower base. However given the lack of real growth in the global economy there is little reason for the increase other than the asset being a perceived store of cash and a limited supply restriction.

We do anticipate the growth continuing for the foreseeable future, albeit without any particular enthusiasm and therefore remain positive property (residential) in 2014. We have greater concerns over commercial property however. Looking at the major Cities of Europe and the US we can foresee a rise in commercial property but expect this to be at a discount to the growth in residential property prices.

6. Equities

Given the limited investment opportunities that appear to exist the equity market becomes one of the few places where growth can be perceived. Of course we are seeing assets coming to market at valuations which are mouth wateringly extreme. We continue to question these valuations and do anticipate a correction to the markets. However we do not anticipate this correction this year. Accordingly for 2014 we are cautiously optimistic regarding equity markets.

7. Predictions

One thing we are certain about is that the number of predictions will increase in 2014. It is the one prediction we can make with absolute certainty.

The author invites your comments via email to DWC@riskrewardlimited.com

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