Source: Getty Images

Dawning of a new era

The banking business model is about to go through substantial changes as it adjusts to a new financial world order being carved out by governments across the globe. William Rhode discerns where fresh opportunities are likely to arise

Politicians around the globe are carving out a new financial world order that could herald in an era of heavy regulation. Possible outcomes include the establishment of a supranational financial authority, a global ban on credit derivatives, the scrapping of the Basel Accord, an overhaul of Bretton Woods, a variety of state-run banking systems and punitive regulatory measures for the securitisation industry.

The question is, how will the banking business model change and what opportunities are there in the future?

The first port of call is to look at the banks themselves and try to understand what shape they will take in the new world. There will likely be two incarnations, experts say.

The first will be the big banks that survive the crisis. Many of these banks will see their businesses go back to basics, along the lines of banking in the 1950s, taking deposits and lending out at higher rates for profit. They will be heavily regulated but, at the same time, they will also be actively patronised under the new financial order, since governments recognise the critical role that these firms play as conduits. They will face less competition and should achieve better loan margins.

"The banks that survive this crisis are going to do extremely well in the future," says Larry Tabb, founder and CEO of the TABB Group, a financial markets' research and strategic advisory firm.

Citing his October report, 'Future of Investment Banking: Subprime and Its Impact on the Industry', he adds: "While they will see their businesses return to basics, the landscape will have been cleared of competitors and their mandate will be to dominate a deposit-based banking system. They will also be able to aggressively cut costs and improve profits as they lay off the many thousands of structurers and traders who populated their investment banking business franchises."

Julian Jessop, chief international economist at Capital Economics, the macroeconomic research company,

agrees. "The big players are going to get even bigger. And out of those I think the Japanese names, like Nomura who purchased parts of the Lehman business, will do very well."

As Tim Congdon, the founder of Lombard Street Research and an economist, points out, "The banks that have lost capital are going to be capitally constrained and so will charge more for risk products, which should help the return on capital, as loan losses on old business are being written off."

He explains that conflicts of interest inherent to the bank holding company model, whereby commercial banks bought investment banking franchises, have been exposed by the crisis.

"Commercial banks participating in investment banking activity ran against the very backbone of the Glass-Steagall Act," he comments. "There will be enormous regulatory pressure to break up those conflicts of interest."

Introducing the i-bank

This segregation of interests will see another type of bank emerge. Larry Tabb expects to see a swathe of mini-investment banks spring up, privately owned and run as partnerships, in much the same way that Goldman Sachs used to operate, before its listing on the New York Stock Exchange.

"There's a few forces at play that will lead to a flourishing of the smaller, more agile investment bank," he says. "First, there's an exodus of outstanding talent from both investment banks and the hedge fund industry, which have been squeezed out of business by the ban on short selling. These people are going to set up things on their own. Second, there are large pools of capital, especially in commodity-rich nations, which will need to find good use. I see human capital migrating towards real capital, to form small investment banking partnerships."

Tabb says the regulators are actively promoting these kinds of firms and encouraging their growth. "These kinds of institutions will be very different to

Julian Jessop, chief international economist, Capital Economics

hedge funds, which regulators have traditionally not liked because they are seen to add nothing to the capital markets," he says. "Investment banks, however, especially if operating on their own capital base, are seen as providing vital lubrication to the capital markets, most especially in the form of structuring expertise."

Adair Turner, chairman of the UK's Financial Services Authority, in a presentation entitled 'Beyond the Current Turmoil: The Future Shape of Global Finance' to the International Banking Seminar in Washington in October, said there will be significant deleveraging in the future and, with it, a polarisation of banking institutions.

"The end point of the deleveraging in terms of financial institutions is fairly clear. A large-scale disappearance of the very highly leveraged shadow banking institutions – the SIVs and the conduits – and the disappearance of most independent investment banks into either alternative ownership or default, the transformation of the remaining ones into bank holding companies with lower leverage. And the increasing concentration of credit extension, trading and capital market activity into the very large universal banks."

Jessop agrees with this theory. "I like this polarisation idea very much," he says. "There will be fewer big players but they will be bigger. And then there will be niche players that will specialise. They will target a sector, say securitisation, and make it their only business. They will seek to attract the best people and leverage their own capital to provide the best securitisation service. It will be a cleaner banking system because these firms will take more responsibility for their practices. They won't risk their reputations and their own capital by allowing toxic assets to filter into the system. There will be clearer delineation in the banking business and it will thus be easier to regulate."

The nature of assets

And what of the markets themselves, experts ask? What kind of assets and securities underwriting will banks migrate to in the new world?

Clearly, credit is going through substantial upheaval and is being targeted by the regulators for reform. In order to understand where the opportunities are, or perhaps the lack thereof, experts say one has to look at the proposals being mooted. One of the big question marks in the market is what lies in store for the credit derivatives industry.

Richard Metcalfe, head of global policy at the International Swaps and Derivatives Association (ISDA), says: "First of all, credit derivatives have done exactly what they said they would do on the tin, which is to provide a precise, targeted means of measuring and managing credit risk. That's why we continue to see new business growth even while economically offsetting trades are being torn up (see figure 1). To say that credit derivatives have failed would simply be wrong."

Metcalfe does agree, however, that regulatory pressure for a central clearing mechanism for credit derivatives is a good idea and is a likely outcome of the credit crisis.

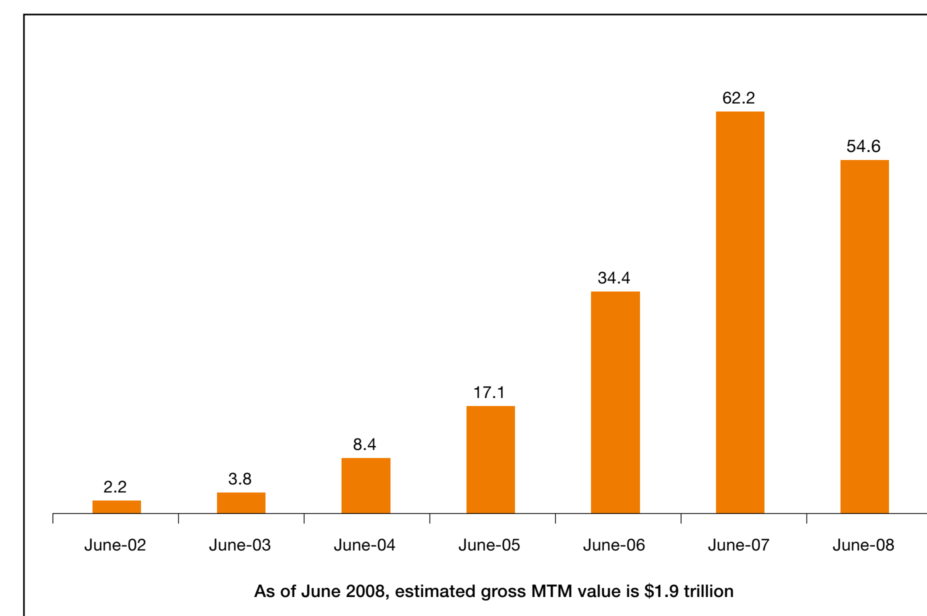
"We've long been major proponents of netting arrangements and any measure that can see the number of outstanding notional values in credit derivatives reduced," he says. "I think it is a good idea to see a central clearing mechanism put in place."

Even though clearing houses are often linked to exchanges, Metcalfe says there's no reason why over-the-counter (OTC) credit derivatives cannot continue to thrive in the new financial world order. Despite the calls for greater transparency in the financial markets, he says that there is no real reason, in principle, or benefit to force credit derivatives to be listed. "Transparency generally emerges where it is needed or desirable. There is more transparency in this industry than its detractors like to think."

Tabb, however, sees the OTC derivatives markets in general faring poorly in the new regulatory environment and, as the calls for transparency mount, higher demand for exchange-listed derivatives will emerge.

"I see exchanges benefiting from the credit crisis," Tabb says. "There will be more demand for opaque derivatives to be listed so that there is more transparency."

Figure 1: Credit Derivatives, 2002-June 2008 Notional Amounts $ trillions



Source: International Swaps and Derivatives Association

The death of securitisation?

Most agree that securitisation was a solid industry backed by sound economic principles before it became tainted by the subprime disaster. Will regulators lump it in with credit derivatives and restrict banking efforts to revive it? The outlook does not look good.

In his final year of office as European Union Internal Market Commissioner, it's clear that Charlie McCreevy wants to make a lasting statement with a securitisation reform proposal that will see banks retain 10 per cent of the securitised products they devise and so "keep a skin in the game" under the "originate and distribute" (OTD) model.

"McCreevy wants to punish banks for draining central banking liquidity," comments one industry body official who did not want to be named. "But, notwithstanding the fact that the last thing markets need right now is to be disciplined, is the fact that the idea is just plain stupid. Whatever the EU is hoping to achieve, will simply not be achieved."

Dianne Hilleard, a director at the London Investment Banking Association (LIBA), says: "We've tried hard to understand the motivation behind the retention reform proposal and it seems the principal concern is to correct a 'misalignment of incentives' in the securitisation chain between banks and investors. But we think this quantitative retention proposal attempts to align the objectives of banks with those to whom they sell securitised products rather than targeting the checks and balances. There are a number of problems with that approach, the most significant of which is that it won't actually achieve the aim it has been designed to achieve."

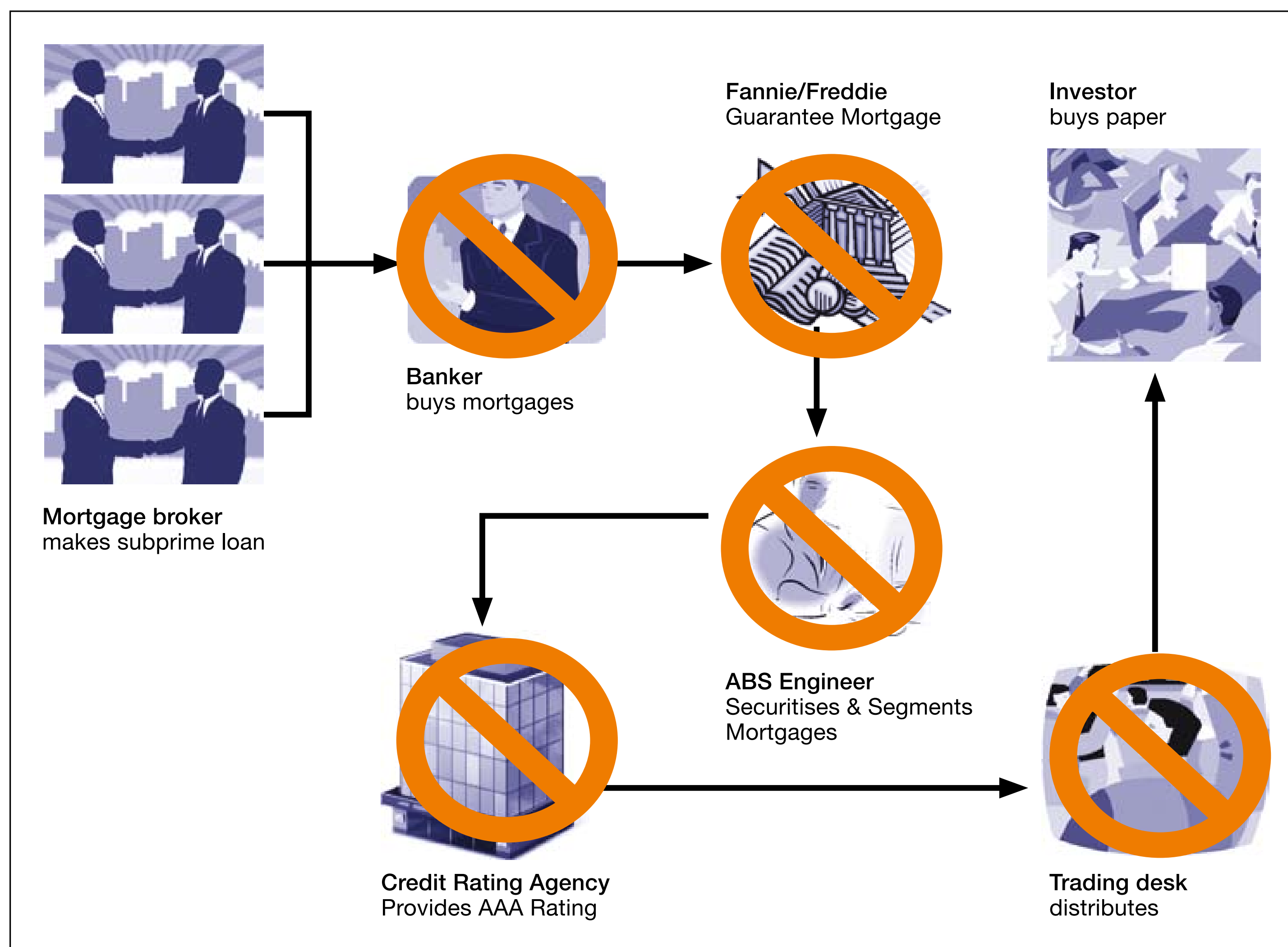
Jens Conert of the German finance ministry wrote in response to the EU proposal: "While we are generally supportive of exploring the use of quantitative requirements to ensure that the economic interests of originators and investors are aligned, we are concerned that the proposal as it currently stands would not achieve the intended result and might possibly lead to competitive distortions."

Tabb suggests that the securitisation industry faces deeper challenges than just regulatory reform. "It's a matter of trust," he says.

He explains: "Everyone involved in the securitisation chain has been tainted, from the mortgage originator through to the banks who bought the loans, to the government agencies, the structurers, the credit rating agencies and the traders who sold the securities on – all of them have been shown to have been at fault, sometimes even deliberately (see figure 2). I don't see the securitisation industry coming back from this because no one believes in it anymore."

Congdon concurs. "If you believe some of the reports, Bear Stearns, for example, offloaded assets onto their fund management clients that they knew to be toxic. That was the problem with the structured finance boom in bank holding companies, the companies that mixed up commercial banking, investment banking and fund management. At some point the investment bank wanted to get failed issues off its balance sheet and the temptation to dump high-risk, low-quality securities on in-house clients was too strong. There was also

Figure 2: Who can you trust?



Source: TABB Group

this dressing up of low-grade issues as something they are not."

Jessop says that to write off the securitisation industry entirely goes too far. "It was a good industry before subprime and it can be a good industry in the future. Securitisation serves an important role in the capital markets, not least because it is such an efficient way of managing and moving capital."

In his speech to the International Banking Seminar, Turner of the FSA said: "Securitisation has been with us for several decades. But in the last decade – with macro demand on the one side and the creativity of financial sector innovation on the other – it had morphed into something much more complex, much more opaque and much riskier [than what it used to be]. Securities were packaged and structured and sliced. Derivatives were used to lay off risks, with huge unsettled counterparty exposures. And a large proportion of the securities were not in fact passed through to end hold-to-maturity investors but held and traded on the balance sheets of banks and on the off-balance sheets of banks (the SIVs and conduits) and in the highly leveraged and increasingly leveraged balance sheets of investment banks."

This raises the question of whether that also means a reversal of the march of securitisation, a return to on-balance sheet lending. The answer is, not necessarily, Turner says. "What instead we may see is a continuation of the originate and distribute model, but in a form more in line with the initial proposition – the packaging and distribution of credits to end investors in a sufficiently transparent and direct and simple form, that end investors, often of the hold to maturity variety, can truly understand the risk-return characteristics of what they are buying, with fewer layers of intermediation and trading."

Regulatory landscape

Governments are also turning their attention to the issue of regulatory capital and the more fundamental question of whether banks are able, even in principle, to regulate themselves. Questions over this theory, which is epitomised in the Basel II Capital Accord, have emerged. And it is throwing the future of the business banking model into doubt.

Turner of the FSA says: "Regulatory regimes will, I am sure, demand more capital in financial intermediation, both via higher capital requirements for banks and via more effective steps to prevent highly leveraged shadow banking entities escaping capital regimes. And there will be more focus on liquidity prudential regimes, and we will need to debate whether that is effected via principles and regulatory review and regulatory discretion, or via quantitative rules."

European Union leaders have called for the creation of international boards to oversee at least the world's 30 biggest banks and financial institutions. This latest effort to step up regulation to address the global financial crisis is based on a proposal by UK prime minister Gordon Brown that could see a supervisory body consisting of regulatory officials from big countries and financial centres.

Brown has said the world needs a "new Bretton Woods", a reference to the 1944 conference in New Hampshire that set up the basic rules for international banking, finance and monetary policy. The goal would be to enhance communication and response plans for bank operations worldwide, regulators say.

"I think this is a lousy idea," says Jessop. "The notion of having a single international authority ruling by committee will be an utter disaster. Without independent regulatory bodies there can be no competition of ideas and the banking business model will be extremely constrained."

Metcalfe of the ISDA says: "We love regulation but we don't think you should throw the baby out with the bathwater. The principles behind Basel II are sound and should be maintained in the new financial world order."

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London's burning

One final element of the picture is the future of London as a financial centre. The head of European financial sponsors at Goldman Sachs has added his voice to a list of high-profile bankers who believe that the market turmoil and growth in emerging economies is threatening the position of cities such as New York and London as the world's leading financial centres.

Responding to a question at a conference in London, John Waldron, co-head of Goldman's European financial sponsors group, said: "I actually think New York and London do have to worry about [losing their dominant position]. The velocity of talent moving around the world is going to accelerate moving from west to east." For this reason, Goldman Sachs is seeking to position itself to take advantage of the rapid growth of cities such as Shanghai and Dubai.

Waldron's comments follow those of Merrill Lynch chief executive John Thain, who in October said that the US economy is "rapidly contracting" and that the oil-rich Middle East could benefit from the global financial turmoil. Speaking to journalists at a conference in Dubai, Thain said: "The Middle East has a great amount of wealth that provides the ability to make investments around the world. The region can take advantage of these financial difficulties."

Stephen Green, chairman of HSBC, told the same conference that the US subprime crisis and subsequent economic downturn have masked a fundamental realignment of the global economy as power transferred from the US consumer to Asia and the Middle East. He said that the fallout would power the long-term expansion of rival financial centres such as Dubai, Singapore, Hong Kong and Shanghai.

However, he added: "London's role in international capital markets will continue to be critical. It has intrinsic advantages that will be very hard to take away." Turner of the FSA offered this perspective: "There are many emerging countries, including the very big ones – China and India – where the demise of some New York investment banks is not fundamental to their financial systems.

"And while the newspapers of the US and UK are full of comparisons with the Great Depression, I think the chances that we are going to face a disaster remotely like the Great Depression are close to nil… We do know that in the face of financial sector collapse, governments and central banks must take, and have the resources to take, exceptional measures. These measures are being and will be taken to the extent needed. Major changes in the financial system will result in the developed economies. But the world will still have a growing economy, largely organised on market principles – even if the financial sector is regulated in a more effective way. We need to keep this perspective." ■