december 2008

Redefining Global Banking – Historic Change, Challenges and Opportunities for Australian Banks

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The last 18 months, and in particular the period since mid-September 2008, will be viewed as one of the most critical and significant in reshaping the future of world financial markets and banking as we enter 2009 and beyond. This period is likely to stand alongside the 1929 stock market crash as one of the redefining moments in banking history. The events of this period may assume even more importance given the huge changes and developments in global markets that have taken place in the last 30 years. Barring any further major systemic disasters, the credit crisis of 2007/2008 and the events which followed the bankruptcy of Lehman Brothers in September 2008, will be remembered as the greatest financial disaster since the banking shutdown of 1932 in the United States.

The period will also be remembered for having a major impact in bringing about fundamental change in the international financial system, the role of governments and central bankers, the regulation of financial institutions and in management practices following the failure, or near failure, of both banks and other large financial institutions in global financial markets.

The Brewing of the Disaster

Up until early September 2008, the credit crisis was creating significant dislocation of wholesale banking markets, major cracks in confidence and lack of trust between banks. There were major questions about the failure of regulation around non-bank financial institutions, investment banks, US mortgage groups, brokers and hedge funds. There were also perceptions of poor judgments and failures by ratings agencies and failures and near failures in banks. This included Northern Rock in the UK, some smaller banks in Germany that had heavily invested in tainted mortgage backed securities, the US Federal Reserve taking action to rescue Bear Stearns by facilitating a takeover by JP Morgan and the nationalization of Fannie Mae and Freddie Mac.

And of course there had been much analysis of where the problems had begun – with the crash of the US real estate market, the massive over-exposure of US banks and non-bank financial institutions caused by bad lending practices in the sub-prime market e.g. NINJA loans and the role of "slice and dice" of mortgages through the securitization and the CDO market.

The complexity and vulnerabilities of the global financial system that had developed over the last 30 years were also being laid bare. What a lot of people did not anticipate was that it was about to substantially damage many of the creators of it and the financial institution participants who funded it. This would eventually expose their unbalanced profit/reward motivations which were based on short term but highly risky gains, poor risk management practices, the provision of irresponsible and high bonuses and fees at the expense of capital, safety and stability.

There were many financial institutions that were operating on thin ice. This was not only investment banks but also many major non-bank financial institutions (e.g. mortgage companies) that joined in without understanding where the risks were. There were also a number of major commercial banks, some of the biggest and supposedly the best that got caught on the tread mill of leveraging high levels of debt and/or investing in mortgage securities and related instruments which they thought were infallible in terms of profitability without any sizable risk.

With the evidence of what had gone wrong apparent as we moved toward the precipice, there were not any real or coordinated solutions in sight. What is clear is that many global banks and financial markets had been weakened by the last twelve months to such an extent that an industry lead solution was not going to be possible. Sovereign funds had been in the financial markets early in the credit crisis looking for opportunities to invest and support many banks and other institutions, but as losses rose, those funds started to retreat and their support faded.

The global banking industry was afloat on a ship that was taking in water without any way of plugging the holes. Clearly, government support and taxpayer money was going to be required but no one could have anticipated just how much. How all this was going to come together was uncertain given the interests of various countries, different regulators and views on how the problems could be solved. On the other hand, very positive and decisive action had been taken by a number of central banks around the world and this injected a vote of confidence in just how quickly these banks with their resources could create liquidity and keep the ship afloat for the time being.

The intensity of the storm was brewing however which would leave many bankers ashen faced and completely stunned.

D Day and Beginning of the Tsunami of Fear and Panic

In the United States, the week end of 13/14 September 2008 was critical, after a week of doubt in deciding the future survival of Lehman Brothers. This was being considered by the Paulson/Bernacke Team and the issue was survival or non-survival through a partnered solution. Evidence was emerging that this was not going to be another government bailout in the event of a failure to find that partner. This could be the first very significant banking bust and bankruptcy in the US during the credit crisis which would have massive and widespread consequences.

With no agreement to find another bank to take over Lehman Brothers (Barclays being the front runner), the storm was unleashed into what became a "tsunami" of fear and despair in the stock market. We were about to be taken to the edge of a meltdown, a disaster that we had never seen in our lifetime with shocks and developments that are having and will have major repercussions for not only bankers, but for the world-wide economy, governments and all associated regulatory agencies.

Whichever way you look at it, the decision to allow Lehman Brothers to fail triggered the tsunami of panic with many immediate consequences including Merrill Lynch being forced into the arms of Bank of America, the collapse and rescue of AIG the largest insurer in the US and the forced takeover by Lloyds of HBOS. It was also the beginning of what would be a series of plunges in the stock markets which would add further pressure and concerns to the survival of many major banks such as Royal Bank of Scotland in the UK. There were also concerns as to the viability of giants such as Morgan Stanley and Goldman Sachs which were finally forced into becoming bank holding companies. This period also saw the failures of the fourth and six largest banks in the US, Wachovia and Washington Mutual. Europe was also being hit hard with financial giant, Fortis, taken to the brink of collapse and similarly Hypo Real Estate Bank in Germany. Iceland went into near bankruptcy and the Swiss Government was forced to support UBS. Finally and more recently, the rescue of what used to be the largest and most successful bank in the world, Citigroup.

Caught in the Fragility and Weakness of the Global Banking System

These events show just how fragile the situation was and how many underlying weaknesses, mistakes and vulnerabilities there were in many banks and non-bank financial institutions particularly in the US. It also showed how the complexity and deregulation of the last 30 years imploded on itself; how interconnected the whole global financial system has become and how swiftly failures can move to bring down banks and financial institutions in other markets. In the end, that big wave of fear and panic gripped the stock markets and ripped at many of the vulnerable banks and financial institutions that were already close to being on their knees.

What has followed is unprecedented in terms of not only failures, but also the rescue of the global financial system. We have also seen some of the boldest action ever taken by major governments to effectively prevent a meltdown of the global financial system. With the words, "we will do whatever it takes" and initial action taken by a very courageous UK Prime Minister, Gordon Brown, in almost Churchillian terms, to make multi billion injection into banks and provide guarantees which ultimately influenced both European Governments and the US to follow with similar support packages, the global financial system appears to have been saved from a catastrophe.

Australian Banks are in a Comparably Strong Position

Australia has also been forced to follow with government support and a guarantee regime, albeit now controversial. Whilst the guarantee of bank deposits was seen as necessary at the time, the vast difference compared to UK, Europe and the US is that Australia has not had to invest actual taxpayer dollars into banks given their comparative high stability and soundness. The Australian government has not had to dip into valuable budget dollars which can be used as a stimulus to the economy.

This is due to the success of the way in which banks have been managed over the last 10 years in respect of risk management and credit (some banks being more successful than others at avoiding credit crisis related losses) and to comparatively tight regulation. It is also due to lessons and experience from the disastrous banking period of the late 1980s and early 1990s where banks were forced to overhaul their credit and lending practices.

Compared to the credit crisis/corporate collapses of the late 1980s and early 1990s, Australia's banks in this credit crisis are in so much better shape: profitable, well capitalized, brands in tact and with no banks failing or needing to be rescued. It is a far cry from the failure of the State Bank of Victoria and State Bank of South Australia which cost taxpayers billions and the disastrous losses that some of the major banks in Australia suffered with real concerns about their ability to survive.

Whilst the Australian banking sector faces some very tough and difficult challenges ahead of it, it does not have any where near either the crisis it had over 15 years ago or the severe problems that many other banks are facing in other markets. In this respect, there should be a large degree of relief and guarded optimism about the future which will provide opportunities in local and global markets that it would not have otherwise had. An example is the recent CBA's acquisition of BankWest and there are potentially many other opportunities both in Australia but also importantly globally where Australian banks are cautiously trying to find new business and market related opportunities.

Future Impact, Challenges and Opportunities

Further attention continues to focus on the US where government support has been required for what once was the largest bank in the world, Citibank, from reaching a serious position of failure. There has been a renewed commitment of $US 600 billion dollars to buy mortgage securities in addition to the original $US 700 million which was committed by the government's TARP program. Total estimates of support that the US government has so far committed to rescuing the US financial system could be more than $US 4 trillion. This is over 15 times Australia's GDP!

The US appears to be on a course that it will do whatever it takes to ensure that their financial system and major financial institutions do not fail. This is critical, as the further stability in the global banking system and the drive to get back to normal functionality of financial markets, very much rests with the US finding more permanent solutions to its problems and instability in its financial system.

As result of these and on going developments, Australian banks are facing a whole set of new challenges in global banking that will take place in markets that will be reshaped and transformed. How banks understand this, position themselves within this environment, manage, anticipate the issues and developments and ensure that both their 'money' capital and 'human' capital are adequate to deal with this environment, may well determine how successful they are in handling both the difficult challenges but also on capitalizing on the opportunities that are emerging.

There will be opportunities given a number of advantages that have been created for Australian banks. All the major banks have their brands in tact and are perhaps glowing compared to other comparable, even much larger banks globally who have taken a beating as a result of serious damage being made to their reputation and power. Experience has shown in Australia and elsewhere, that recovering your brand reputation after being substantially damaged can take years. In addition, there has been a serious decline in non-bank competition, a major weakening of regional banking competition and major banks have had a huge boost to their deposits. Australian major banks are in a group of only 18 banks worldwide with an AA credit rating.

This all points to providing further opportunities to gain new business, more opportunities in mature, new and emerging markets, in major bank/financial institution relationships and potentially taking over business from other large banks whose balance sheets have been so badly affected they can no longer support that business e.g. the retreat of international banks from corporate lending/syndication market.

Some of What is to Come

We are moving toward a future in global banking where there will be changes in competition, markets, operations and structures of banks/ non bank financial institutions, regulation, transparency, culture/ management practices, risk verses stability/safety, capital/liquidity and more.

More specifically:

- Forced and opportunistic consolidation of banks/other financial institutions and the possibility of major global banks emerging particularly in the US. As one observer put it: we have seen consolidation/mergers/takeovers taking place that you expect normally to take ten years or more occurring in the space of just 10 days. This will have a dramatic impact on reshaping banking particularly in the US where some of the potential mega banks will be Bank of America and JP Morgan Chase followed by Wells Fargo with a next tier of super regional banks and a substantial loss of smaller regional banks;
- Other global banks, such as HSBC who have weathered the credit crisis storm very successfully compared to many other competitors, will also emerge with more power and strength in the future given their limited losses and maintenance of their solid reputation. The major banks of Japan have also performed extremely well with their huge balance sheets, liquidity and no sub-prime debt and have already picked up US banking investments and opportunities such as Nomura's estimated $1 billion acquisition of the Asian and European businesses of Lehman Brothers and Mitsubishi's objective to become one of the top five global financial institutions in the world;
- Major regulatory reforms for banks across several areas and "regulation" of non bank financial institutions, greater capital requirements and changes to liquidity requirements including tighter ratios of deposits to wholesale funds;
- A need for the global banking industry, e.g. through bodies like the IMF and BIS, to work with the regulators to identify where are the further major risks in the financial system and what needs to be done about it. One critical area for review and regulation is the credit default swap market (CDS). The estimated US$60 trillion market in the US alone is unregulated and there have been major concerns about whether this market is at risk to cause even more major problems that we have seen from the sub prime fall out.
- A shift away from complex products and models that will impact structured markets/financing and will restrict the ability of financial institutions to "innovate" and "engineer" in financial markets. Plain vanilla and transparency will be dominant features for the immediate future;
- A radical change of thinking in terms of culture/ management practices that will need to review the pursuit of "profit risk" balanced much more heavily against greater safety, stability and capital;

- A sweeping review of salaries, fees and bonuses that are linked to risk/long term performance and do not compromise capital/cash reserves. Some statistics highlight the problem – in the UK in the last 4 years, bankers shared more than £31 billion in bonuses according to the Centre for Economics and Business Research. The FSA has already begun an examination of City of London bonuses and remuneration packages. In the US, is was reported by Bloomberg that Wall Street's five biggest companies handed out $US 3 billion in the past five years to their top executives while they presided over the packaging and sale of loans that helped bring down the investment banking system. Congress has condemned the wide spread abuse and greed that has taken place and indicated substantial reviews of salaries, bonuses/fees and golden parachutes;
- Investment banking, particularly in the US, has had much of its business and credibility destroyed which will have longer term implications for operations, profitability and competition. This will bring about changes to practices, models and greater regulation e.g. Morgan Stanley and Goldman Sachs being forced to become banks and subject to increased "bank" regulation; and
- An increased focus on management expertise and qualification in senior management, CEOs and boards relating to direct knowledge, experience in banking operations, much greater appreciation of risk and understanding of global financial markets.

This is only some of what is to come.

There are also going to be longer term consequences for banks in raising debt/equity, mechanisms in those markets, the competitive and cost impact of banks with AAA government backed rating compared with those that don't. There will also be issues as to what survives in the structured product market and what changes will be made. The role of non-bank financial institutions and their lack of capability to raise funding particularly in the mortgage market and the role of hedge funds will likely come under further regulatory and transparency disclosure pressure. There will also be an impact on government funding of banks in terms of control over those banks and long term implications and impact on the business/risk appetite of those banks in the market. For example, in the UK, under the terms of recapitalisation support scheme, banks will have to resume lending to customers at "2007 levels" for at least three years and help home owners struggling to pay mortgages.

The Train of Review and Regulation – Coming to a Bank Near You

One of the biggest impacts is recognizing that we have a set of events that are so unprecedented in terms of exposing failure and weakness of many banks and non bank financial institutions particularly in the US (but also elsewhere including the UK and Europe) and their regulation, that governments and regulators have already begun a journey to completely lay bare what was previous hidden and create a radical 'reflective' review of the regulation and control of financial markets and these institutions. No one should underestimate just how vigorous this review and reflection is going to be and what consequences will flow from it.

In Europe, the ECB President Jean-Claude Trichet has made it clear that as a result of banks having mispriced risk, financial markets should be subject to greater transparency and regulation to curb their volatility. There has been a major shift of power to governments to do this and make decisions that the banking industry will have little bargaining power to fight. Banks in UK, Europe and US are not in a position to resist where substantial taxpayer funds have had to be used to prevent bank failure as opposed to Australia where, despite the guarantee creating contingent liabilities on taxpayers, there has not been a need to actually allocate any funds. However, the Australian government is trying to flex its muscle to a more limited extent; as an example, it has boosted the powers of APRA as part of the guarantee measures to takeover and liquidate failed banks.

The days of the light touch approach to regulation that was evident in the approach of the UK to attract business to the City of London and the Financial Services Authority are well and truly over. The reversal will be quite dramatic. This all began to change as this credit crisis got underway and reached a turning point with the failure of Northern Rock in 2007 and lead to strong criticisms about the failure of the Bank of England to take earlier preventative action. There was also criticism of the role and co ordination of banking supervision by the Financial Services Authority and Treasury. Major changes to the Bank of England's powers to deal with such failings were proposed. Indeed participants in B@nkfin's 2008 Global Banking Program were introduced to the structure of the system before it could be used given the events that followed in early September 2008 with HBOS, Lloyds TSB and Royal Bank of Scotland.

To give an example of what is now likely, in late October 2008 the Bank of England, in its Biannual Report called for a fundamental rethink of how to manage systemic risk internationally. The BoE has recommended that a new "leverage ratio" be implemented with a minimum ratio of capital to assets to which individual banks must be able to conform and also backed a system of dynamic provisioning which would force banks to build up reserves in the good times which they could draw on when times are tough.

In the US, calls for overhaul of regulation are louder than a rock concert. The reason is simply that deregulation of the financial system was seen as one of the major causes of the current disaster. Roger Altman, the former Deputy US Secretary under Bill Clinton, as reported in the *Financial Times*, said following the crisis that followed Lehman Brother's collapse:

"This will come to be seen as the greatest regulatory failure in modern history. The degree of leverage that these institutions took on is indefensible. The average large securities firm was leveraged at 27 to one in mid 2007. They were not regulated by any prudential supervisor. In effect they regulated themselves. The lack of transparency was stunning. Many big lenders did not disclose off balance sheet risks. In some cases they did not understand these risks themselves. More fundamentally, we allowed a second huge financial system to develop outside the normal banking network. It consisted of investment banks, mortgage finance companies and the like. It was unregulated, not transparent and too leveraged."

Working Through the Repair of the Financial System

The process of working through the repair and dealing with on-going risks in the global financial system is not over. Clearly, whilst the situation has improved post mid September 2008, there are still many uncertainties ahead and in particular how the US bail out and continued rescue policies will play out and the impact on banks and financial markets both there and globally. One cannot underestimate this and the further potential risks ahead as well as what further problems may be caused by the global recession and business of banks/losses in consumer debt, real estate and corporate failures.

As we emerge however from the more immediate crisis of systematic instability of the banking system and provided the fallout on major global economies does not further significantly impact on what has already taken place, there will be more and more focus on identifying what went wrong, where banks need to change, what were the regulation failures and generally how the global banking system can be reformed so that banks, financial markets and governments are better placed to avoid facing the same risks in the banking system that drove us to the edge of a meltdown of the global financial system.

In the end, we need a global financial system that can maintain many of the great advantages and developments that we have gained over 30 years but ensure that its complexity and risk is appropriately reviewed, reduced and regulated having regard the events of the last 18 months. At the same time, we need to have a banking and financial system that is not open to abuse and greed and where people who are employed in the industry can be appropriately rewarded fairly in the light of weighing what valued contribution they make and the risks they carry.

The Big Challenge for Australian Banks

One of the greatest challenges for banks in Australia will be in understanding and managing many of these issues, reassessing businesses/operations/structures that will not only provide a solid basis for survival but will also capitalise on the changes and position for opportunities in the future.

We have worked with the Australian banks in global banking markets at increasing their experience and knowledge of financial markets and creating better understanding of global banking. Our work through our highly regarded global banking programs has given insights, and opportunities, with many global banks in respect of their businesses, models, vast experience and more recently lessons learned from the credit crisis that they would not have otherwise gained. These are the markets and the banks (together with the regulators) that are determining the future of global banking, who survives, on what basis, what size, what businesses and which competitive strategies.

Global banking is now so heavily interconnected, that a major bank's success in the future is going to depend on how well they understand and manage this environment as it is redefined and transformed by the events of the last 18 months. That can only be done by having the best practical knowledge and understanding from those markets and the successful major banks that operate in them.

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