Regulatory and Growth Challenges Face Global Banks

Introduction:

Knowledge@Wharton: Thank you for joining us today at Knowledge@Wharton. We are here to discuss global banking and capital markets with Mauro Guillen, a Wharton management professor and also director of the Lauder Institute; Steve Ferguson, who is the Leader for Banking in Asia & Pacific for Ernst & Young and who is based in Sydney. And also Ian Baggs of with Ernst & Young where he is the deputy global banking leader and based in the U.K. Thank you, again, for being with us. Welcome to Knowledge@Wharton everyone.

Are Markets Pricing Re-regulation into Equity Values?

Knowledge@Wharton: I would like us to look at what will likely become some of the key drivers in global banking and capital markets in the short and medium term given the many changes that have been brought about by the financial crisis and the re-regulation that is going on regionally, nationally, and globally. And so my first question for you is, should banks shore up their balance sheets with more common stock now before Dodd-Frank and Basel III reduce their returns on equities? Or are markets already pricing this re-regulation into the equity values? Mauro, perhaps you could begin for us.

Mauro Guillen: Well, I would like to take on the second part of the question. I very much doubt that the markets have already anticipated what is going to happen because we still don’t know how the banks plans to implement on their own balance sheets and there are multiple ways in which one can meet, in particular, Basel III guidelines. And what is important about Basel III is that they not only change the thresholds for capital ratios, but they also change some of the rules. It is actually very hard to anticipate exactly what banks in various countries around the world are going to do in order to meet those new requirements. So, as I just said, I very much doubt that capital markets are in a position right now to anticipate what the banks are going to do and, therefore, I don’t think they have already priced the new regulations into their assessment of the banks.

Knowledge@Wharton: Thank you. Ian, does that mean it is a good time to shore up balance sheets?

Ian Baggs: Well, it is going to be interesting seeing how this year, 2011, progresses. There is an awful lot of information coming out in the quarterly earnings calls with banks saying that they feel they are well-positioned to meet the requirements of Basel III. But I think, as Mauro said, this is something we have yet to see how that works through because, particularly for some of the largest firms – the systemically important firms – we don’t know what the extra capital charges are going to be that will be applied to them – let alone some of the detail of how the detail of this gets applied when you get down into the different countries.

I think what you might then see is certainly a lot of talk that you will see different dividend policies this year as a result, because some of the banks feel they are well enough positioned to start to give capital back. Others may feel they have got to maintain that for the time being – start building up capital through that.

I think you will see some change around the other components of Tier I – the need to think about how you shift some of the hybrid type structures people have used in the past within capital and maybe moving it to some of the CoCo (Contingent Convertible bonds) type instruments. So that will be quite interesting. A number of the banks are saying that they have appetite for issuing contingent capital type structures.
Recapitalization in the Asia-Pacific Region

Knowledge@Wharton: Steve, in the Asia-Pacific area – things are a little bit different. They didn’t suffer quite as much as say Europe and North America. But, from your point of view, is this a chance for them to take advantage. They don’t necessarily have to recapitalize in the same way as let’s say Western banks, but certainly they are in global markets and could take advantage of higher equity values right now.

Steve Ferguson: Yes, you are right. The banks in Asia-Pacific did come through the crisis somewhat differently – [there are] a couple of key reasons for that. First of all, [there is] a very strong deposit culture in Asia-Pacific, which meant that the banks – many of the banks – weren’t actually as short-term funded as other banks throughout the U.S. and Europe. What that means, I think, is that many of those banks have taken the chance to increase the level of funding. So most banks across Asia actually think from a capital perspective – I think they are actually reasonably well-placed. What is worrying them most about Basel III is actually the liquidity measures. Those are the ones that as Ian has said are not actually all that well defined yet. So I think we will find that that will be the major impact through Asia-Pacific.

And the funding the banks are doing now is more medium to long-term funding. They have moved away from short-term funding. That has cost implications. So what we are seeing is that the additional capital is being raised is putting pressure on the margins. And that is what the market is valuing right now. It is taking account of the reduced margins because of the increased cost of funding.

Knowledge@Wharton: Is that going to be a long-term strategy do you think for the banks in that region -- to increasingly fund with medium- and longer-term funds versus shorter-term funds?

Steve Ferguson: Well, I think it will be. I think if you take China as an example, much of the banks’ growth to date has come from internal measures. Again, I mentioned that strong savings culture throughout China. Going forward they will need to go to the market to increase the growth that they would like to achieve. So that will mean that the financial markets will become more important to the banks in Asia-Pacific.

The Impact of Increased Regulatory Costs on Customers

Knowledge@Wharton: How should banks decide whether to pass on increased regulatory costs to customers or exit product lines? They will likely have to decide soon because new limits on capital liquidity leverage under Basel III – along with increased derivatives reporting and clearing and collateral costs under Dodd-Frank – are expected to make capital intensive bank products less profitable.

Ian Baggs: The extra cost of all of this regulation coming through -- I think it is very difficult to see the banks can do anything but pass that on to their customers in one form or another. So the question really does become how do you work through how much you are getting as a return out of different product sites? Some of that becomes kind of self-selective. You can see that for the more complex products that have got much higher capital charges there is already a diminished appetite for that kind of product anyway.

Knowledge@Wharton: Could you give an example or two?

Ian Baggs: I think for any of the really complex capital market structures that we have seen, any complex leveraged OTC derivative structure, this has become far more difficult. The regulators are looking at particular capital add-ons within the way that you calculate regulatory capital. There is a lot of very detailed discussion going on within different regulators with each of the banks and their locations as to how to charge for that. And certainly we are seeing in the U.K. a concept of what the regulator would call prudential valuation, which is an interesting concept. So it says that you may have an accounting valuation, but we want you to take an addition hit for what we think is prudentially something you should be more conservative with.

Knowledge@Wharton: Extra reserves?

Ian Baggs: Extra reserves. It is becoming very challenging to make those kinds of products work. But also I think the appetite within customers has gone down significantly so some of that is sort of self selecting. But trying to work through this problem to my mind I think is more about understanding your customer franchises. And, therefore, if you have the ability to go to market around that – that’s where you will see benefit and value, and you will stay in those businesses. But if you don’t have much of a franchise it becomes much more difficult to make these product sets work.
Knowledge@Wharton: Steve, I imagine that there is a huge regional difference when it comes to these kinds of things also. Perhaps you could talk about the effect in your region.

Steve Ferguson: Yes. So banks throughout Australia or up into the Far East have traditionally not been extensively selling the complex financial products that Ian spoke about. Many of the domestically-based banks there have really built their franchise around a strong retail consumer base. So they are less impacted by some of those measures, which is also why they actually went much better through the financial crisis -- they didn’t have to take the write-downs. So there is less impact for banks through the region. What is going to make a difference I think is that as they look externally into the major international banks in the U.S. and Europe for their funding -- which we have sort of talked about before -- I think that will have an impact on how they go about getting their funding.

Knowledge@Wharton: Mauro would you perhaps add to this?

Mauro Guillen: Well, I think the more general – just very quickly – the more general answer to this question, I think, will depend on to what extent do we believe that there is more competition in the relevant market segments and geographical areas for these customers -- to what the extent that the crisis has actually forced some banks out of business, and to what extent others are not able to do the kinds of things that they would like to do because of lack of funding. So, if there is reduced competition then I guess absolutely I agree with both Ian and Steve that customers are going to pay for the additional costs.

Now to the extent that we see a normalization of financial markets and maybe, let’s say, three, five, seven years down the road, financial markets go back to normal, hopefully, then there might be more competition among the banks and the relevant players, and I would then expect customers to get a better deal as they shop around. But right now for the next two or three, as long as the credit crunch continues and all of these things play out, I would predict that customers are going to have to pay for the extra costs.

Ian Baggs: That is absolutely right. I think there is also – maybe some differences between what you see in the capital markets and the wholesale banking market versus what we see in the retail market. And certainly some parts of particularly Europe and the U.K. will be a good example, but a number of the countries around Europe there are a very large number of banks out there competing for retail banking business. Typically, in the past, that has been done on the basis of free checking accounts, free banking products and a huge amount of things that you get for free.

I think that is going to make life very interesting because, first of all, most banks can’t afford to carry on providing these services for free. But there is also this huge competition for the customer base. So understanding your market and your brand, and your positioning and what the premise is that you can take to your client -- why they want to have their banking with you. That is going to be quite an interesting development. Arguably you will see a lot of consolidation I think across the sector.

Knowledge@Wharton: So pressure on the margin where you are perhaps funding more medium and longer-term, and then on the opposite end with the consumer who is looking to keep a lot of these free services. Banks need to offer them or perhaps have to think about whether they can offer them or not.

Ian Baggs: Well, that becomes a really interesting question, doesn’t it? Because there are certainly a number of firms that have become relatively new entrants into the retail sector trying to gather deposits and then lend off the back of that. But to do that they have to offer very attractive rates of interest, and with the way the world is these days -- it is so easy to move your deposits around -- will those new entrants be able to retain that? Or if they do retain it, what is the impact on the other participants in the market, because arguably it is just over-banked as we look forward the next years.

Regulation’s Effect on Existing Business Lines and Talent Retention

Knowledge@Wharton: Should financial services companies try to retain top proprietary trading and fund management staff that are now leaving banks in anticipation of the regulatory changes? Or will these staff have no useful purpose in the future? Ian, maybe you could tackle that one?

Ian Baggs: I think there is clearly massive pressure from regulators, from governments, and many different people around the proprietary trading model and risk taking. So we have already seen many of the global firms reduce their reliance on that kind of activity for their revenues. We have seen teams leave various banks. Sometimes that's the “prop” desk. Sometimes it's more the principle investing private equity end of their business. But I
think you do see some of that taking place in the form of them moving to funds or new fund start-ups where the banks will take a stake. They are clearly limited depending on what rules and regulations you face, particularly in the U.S. But I think they are still going to exist -- but just in other vehicles. And then what will the relationship be between the new vehicles and the firms themselves? So that will be quite interesting to see how much exposure they really end up having. And I guess some guys will end up in asset-management firms. And maybe if you can move some of the people to your asset-management arm to generate returns, again within that business, that's the way you can make great use of their talents but in a risk-controlled way.

Knowledge@Wharton: So some will move into other organizations or some will move within their own organization?

Ian Baggs: I think that's right.

Knowledge@Wharton: And even the ones that move out will retain some connection and relationship – most likely?

Ian Baggs: Almost inevitably.

Knowledge@Wharton: Mauro, do you have a view on that?

Mauro Guillen: Yes. I could be wrong. I agree in that there is going to be changes and reallocations of personnel. There is no question about that. I think the – it is just too tempting to do proprietary trading, especially at a time when you have financial market volatility. This volatility – which I think is here with us to stay for awhile – just is very conducive to trying to make money through these activities. So I totally agree that there is going to be quite a bit of reallocation and reorganization or restructuring. Some people may leave. Other types of firms may be founded by some of those teams. Maybe perhaps they want to go solo.

But I think the banks will, within the new constraints – and some of them are going to be quite onerous, especially here in the United States – keep on trying because the opportunities are going to be there, especially when we have very low interest rates and high volatility. Now if those things change then there may be less of an appetite for these by the banks. But that would be my – and I could be wrong – but that would be my take on it in addition to what Ian said.

Ian Baggs: I guess within that if some of the very successful proprietary traders move into different vehicles then the question becomes how able are they to persuade external investors to support them?

Mauro Guillen: Good point.

Ian Baggs: So how big a fund can they raise? And how much leverage are the investors prepared to accept within that fund as part of the deal to invest?

Mauro Guillen: Yes, absolutely.

Steve Ferguson: Now I think the focus on remuneration is going to be one of the most challenging aspects for a publicly listed bank, irrespective of the environment in which you have come from through the financial crisis. There are additional requirements of remuneration. So to give you an example – in Australia where we had a relatively successful financial crisis – the banking regulator, APRA, has introduced rules that say that the Board must have its own independent remuneration advisor. The focus there is clearly to put pressure on the boards to make sure that they are not paying excessive salaries or bonuses to the traders. So I think it is one of the most challenging aspects banks will face of the next five years.

Ian Baggs: Well, I guess one other quick comment is the way that the rules are being implemented around restrictions on proprietary trading and risk-taking do vary across the countries. There are going to be some countries whose institutions are not as restricted, and so you will see some traders move from one bank to another where they still have the opportunity to operate within that structure.

Mauro Guillen: Absolutely. This I think is a very important point. We may see a race to the bottom here in terms of the minute – this is why this negotiation right now is so important over implementing new standards. The minute a major financial center settles for less regulation you are going to see a movement by necessity of everybody else then scared by the prospect of losing financial services employment. It is 10% of GDP in many countries. So this is another issue that, I think, is going to get very complicated.
The Volcker Rule and Regulatory Arbitrage

Knowledge@Wharton: Do you think the Volcker rule is a major fulcrum for this issue?

Mauro Guillen: I think the most important aspect is how many countries – like with climate change – how many countries are actually going to agree to do this? Are the crucial countries in the world of financial services all going to be on the same page? But I’m not sure whether Ian and Steve will have a different view on this, but my sense is that we could see a situation in which – yes, we are very keen on regulating now but as soon as one major country starts to [there could be important repercussions].

Ian Baggs: That is a really an interesting question because there are a number of different aspects that drive how comfortable you are about the business environment that you are in. There are aspects of employment law that are particularly important to the banks, so that they feel able to grow their workforce as well as reduce it when they need to. There is the legal system that you operate under. So it does start to reduce perhaps the number of locations that you can arguably set up a major banking presence and operate out of.

So I don’t know – there is no point in choosing a particular country, but if you took a small country that happened to go with a very low set of requirements not everybody is going to go there because it won’t be a location that counterparties will necessarily want to contract with and be exposed to. But among the major locations there is certainly a possibility that if someone there goes with an easier set of requirements then we could see a move there.

Knowledge@Wharton: And this is in effect regulatory arbitrage, yes?

Ian Baggs: Exactly.

Ian Baggs: Well actually, it’s probably even more complicated than that in terms of where some organizations were and whether there was overall regulation at the consolidated holding company level. [There is] a whole range of questions that you end up with.

Mauro Guillen: Absolutely.

Steve Ferguson: The G20 goal of having global regulations for banks sounds very nice. But when it comes to the practice, each country has to make sure that the banks operating in its environment are relatively safe. And that will force countries to operate differently. That is, again, going to be such a big issue over the next several years. Even the early implementation of Basel III will be a disadvantage if an economy chooses to take that on.

Mauro Guillen: That’s right.

Steve Ferguson: It is going to be very, very challenging.

Mauro Guillen: It is a huge prisoner’s dilemma if you want to put it that way. You come to the table. You agree on things. And then everybody goes back home. Then, okay, so we have agreed to something that we actually implemented very quickly or not. How about the others? Are they going to do it? It is messy.

Ian Baggs: There are a number of very good examples now and unfortunately (one) is the U.K. where we are having additional requirements put around remuneration and remuneration policy – more stringent than other locations. We have additional levies and taxes coming out, which again is just is really being the market leader in some of this. It is ultimately perhaps good for the system, but economically it is going to put some countries at a disadvantage.

Knowledge@Wharton: And, interestingly, in the U.K. where there seems to be bigger moves afoot at the moment than elsewhere -- where there is talk not just among the regulatory authorities of perhaps breaking up some banks or unwinding some of the mergers and acquisitions that took place when there were difficulties. But even some former bankers of those institutions seem to support the idea of unwinding or breaking up those banks. So the discussion seems to have – you could either say progressed or else gone off into a totally different direction in the U.K. – and so being based there, Ian, what is your view of that?

Ian Baggs: I think we have been really waiting to see what happens later this year when the banking commission comes out with its report. There is an awful lot of debate and discussion going on. There is lots of talk about [a major] type separation taking place or certainly a separation in terms of capitalization of the wholesale and capital markets business from the retail business. But I think most of the bankers and most of the city of London is sitting there saying we don’t want to see that and we think that would be bad. It would be bad for the U.K. and
we do not want to be the first mover on this. In many ways what you are seeing around what we talked about earlier – the change in regulation and the capital requirements around the systemically important firms -- is going to cover an awful lot of these issues so I think we will see how things go. But there is a lot of lobbying to be gone through yet.

Global Banking Challenges – Emerging vs. Developed Markets

Knowledge@Wharton: How will the challenges that banks face in the emerging markets – such as Brazil, India, or South Africa – differ from those in the more developed markets – such as Europe and the U.S.? Mauro, maybe we will begin with you.

Mauro Guillen: Well the challenges of the banks in those specific markets are actually perhaps answered in terms of the great opportunity that they have. In those three countries you do have indigenous banks. Brazil is the only country in Latin America right now that has large well-capitalized domestically-owned banking institutions. The country is doing well. Many of the customers are moving into other markets – industrial firms and so on. So they have a golden opportunity now. They haven’t been affected really by the financial crisis. So I would say that they happen to be in a great moment now to pursue international opportunities and, also, quite frankly – I hear this from my students – to attract top talent. So I am not so sure about Indian banks or South African banks, but certainly Brazilian banks right now can actually grab some of the best people around because everybody thinks that Brazil is the place to go. And they hear, of course, that the banks are doing reasonably well and, I doubt, that Brazil is going to place caps on bonuses or remuneration.

Ian Baggs: Yes. I agree.

Knowledge@Wharton: Steve, operating in Asia certainly we could add perhaps China to that list. With China and India, how would you view the situation there?

Steve Ferguson: There are a number of different scenarios that come out through Asia-Pacific. Firstly, if you dealt with China – those banks which are still state owned are looking to expand globally. Certainly the major two have large global footprints already. And then if you go to the other parts of Asia such as Vietnam and Malaysia – those banks there are largely domestic, doing reasonably well, and will look to grow probably internally within their country at first, but they may look externally as well. So I think there is – in fact, what we might see a lot more of, is banks from emerging countries taking over other emerging country’s banks if you like. So I think that is a trend that we have started to see already.

Knowledge@Wharton: So consolidation within Asia.

Steve Ferguson: Within Asia – within the emerging countries. That is a trend that has started and it may well continue.

Ian Baggs: And I guess maybe seeing some of those banks also taking strategic stakes in institutions in the West. We have seen some activity along those lines.

Mauro Guillen: In non-financial firms or financial firms?

Ian Baggs: And maybe in banks, too.

Openings within the Chinese Banking Market

Knowledge@Wharton: And what about prospects [within China], for example, we see the tiniest openings in capital markets in China in terms of them allowing some investments to move from China into the West. I’m not talking about foreign direct investment but, say, in capital markets – bond investments and that sort of thing. [There are] huge [numbers of] savers hungry for higher returns presumably, but there are a lot of capital controls that keep that money in China. Is that likely to change and, if so, when, and how big of a deal would that be?

Steve Ferguson: Yes. It is a very interesting trend and I would be loath to predict a timetable. But I believe that it will be a growing business for financial markets, for companies in China looking to fund from outside China. I think that – you are right. We are starting to see that already. And certainly it is one of the areas that we see as a potential growth opportunity because the major banks and the other major corporations in China do need to start to fund externally.
Knowledge@Wharton: And as global leader is that very prominent on your radar screen also?

Ian Baggs: Yes. I think so. I think when you talk to most of our clients they would say in terms of where the growth opportunity is going to come they do not see it here in the U.S. They are uncertain as to where it would be in Europe. And if it’s going to be in Europe it is going to be more in emerging Europe. But then at the moment there is an awful lot of economic stress going on within a lot of those countries on the fringes of Europe. So that is a real challenge. And most people are talking about Asia as the place where they feel there will be a great growth opportunity. I think even if you talk to institutions in Japan they would look to Asia again to be an area of growth rather than within Japan. So everybody seems to be talking about Asia. And as soon as you talk about Asia the first place you talk about is China. So everybody is focused on that country in particular but without quite knowing how you are going to be able to progress that particular strategy.

Knowledge@Wharton: Very complicated given the capital controls and state owned banks. It is basically a state controlled system. But there seems to be openings.

Ian Baggs: Right.

Knowledge@Wharton: Or at least the beginnings.

How Do Banks Rebuild Trust in Emerging and Developed Markets?

Knowledge@Wharton: The financial crisis has affected retail depositors in various countries differently. So, for example, in India where the crisis didn’t have that much effect consumers there still have pretty much the same view of banks that they had before. But, of course, in the West, a lot of polls are showing that there is very little – even no trust – in banks after events. So should banks in regions that have been negatively impacted by the crisis work hard to rebuild trust? Or should they see that their time and energy is best spent in what might be called reputation arbitrage – in other words, putting the time and effort into those regions where there hasn’t been so much damage and so where presumably they might get better returns?

Mauro Guillen: Well, with the only possible exception of North Korea I think the crisis has affected the reputation of banks everywhere. So I think it is not an option just to give up places where – but, you know, all of the bankers I know, at least I think deep inside them, what they would like is not to be in the spotlight. So they would prefer their bank not to make the headlines. They would prefer – so whatever they do in terms of building back the trust and the reputation for being well managed and institutions and all that, really they don’t want to win any awards. They don’t want to appear in the news. That I think is the best situation for them. So they are going to be able to do what they do without either very positive or very negative public opinion reactions to what they do, especially when the remuneration systems are under attack. So, I think for them, being under the radar screen of public opinion would be the best possible situation. It is hard and it will take a little bit of time to rebuild the trust and to rebuild the reputation. I think they are better off trying to muddle through this situation without doing anything public relations wise too drastic, and just trying to rebuild the trust quietly. And, hopefully, in three or four years, people will have forgotten about the crisis, which is by the way what typically happens. People forget about financial disasters and that’s why we perhaps get them so frequently.

Ian Baggs: That makes a lot of sense. Staying under the radar has got to be pretty much every bank’s aim at the moment. The customer focus I think is very important for most of the firms -- whether you are in wholesale or retail or both – being able to reassure your customers that you are focused on providing them with good service and doing that in a very trustworthy, above-board way. Very often you may not actually have had a specific issue, but the whole of the crisis has tainted that reputation and I think that is very much [the case], as Mauro was saying – so trying to reassure customers that you are focused on providing them with a high quality service has got to be paramount.

Knowledge@Wharton: A bit of an easier job in Asia-Pacific?

Steve Ferguson: It is an easier job, however, banks have still suffered a little reputation damage. What’s interesting now is that they have – many of the banks in Asia-Pacific have a very strong customer focus and they are really building out plans to increase their penetration across their customer base. But at the same time they are being forced to pass on additional cost of funding through to the customer. So it actually is quite a dilemma.

But there are very major programs on to improve the attention paid to customers. In fact, what is really happening as banks in the U.S. and Europe are spending a lot of money and time fixing regulatory issues, the banks in our part of the world are spending that time and money on better systems to deal with their customers. So it’s really quite an opportunity for them if they can pull it off.