



Linen Hall
162-168 Linen Hall
London
W1B5TE

T: +44 207 038 3690
F: +44 207 038 3693

www.4-most.co.uk

Author:
Mike Lawrence

The Future of Banking

The current banking model is broken.

The idea of the universal or retail bank is going to die within the next few years – at least for many of those banks currently following this model. Why should investors risk their capital by depositing money with a bank that has significant potential losses from bad loans of all types? A higher credit spread does not protect against loss of principal. The strategic merger of investment banks with retail banks, previously as a positive competitive move, lately as a negative protective move, in order to create a universal bank or larger retail bank, no longer makes sense.

Investors, both retail and corporate, are looking for 'clean' banks to which to lend their money. The likes of Tesco is leading the way, although it is not clear that this is part of the strategic rationale that Tesco is following itself. But this will become clear to them as more and more retail and corporate deposits flow through their doors (conveniently located within their existing supermarkets?). This is third-level disintermediation, which even the UK local authorities are investigating. These clean 'corporate banks' will rapidly grow their deposit base and must be prepared to start looking at the corporate lending side of the business, as they will need something to do with their increasing deposits – if they don't want to take risk on lending excess funds to the retail/universal banks.

So retail/universal banks are under threat of losing their deposit bases. They are also going to be excluded from the wholesale markets as their credit ratings decline in a positive feedback loop with their declining deposit base.

But the retail/universal banks will also be threatened from the other direction by a new type of capital market boutique organisations. These will be based around the old and discredited 'originate and distribute' investment banking model, but instead run on a non-underwritten basis. All the boutiques will require is the knowledge of the investor base and the issuer base, in order to put deals together on a best-efforts basis. The boutiques will be primary market specialists, without any research, underwriting or positioning abilities. This will also threaten the remaining investment banks, whose large cost base will disadvantage them compared with the bou-



Linen Hall
162-168 Linen Hall
London
W1B5TE

T: +44 207 038 3690
F: +44 207 038 3693

www.4-most.co.uk

Author:
Mike Lawrence

tiques. It will be the knowledge embedded in contacts and people that drive business, not willingness to take risk, because the new capital and liquidity requirements will seriously erode the ability of any regulated entity that takes risks, to make any profit. The ability to warehouse positions for later sale will be expensive and the issuers will no longer expect the type of liquidity that used to be offered by primary and secondary market makers.

The broking organisations will also benefit from the changes, because, without major positions being held by banks – especially proprietary desk positioning - the main trading counterparties will be the end investors, whether corporate or retail, who will not have the personnel or expertise to undertake the price discovery required by regulation.

However, until this future becomes clear, the universal/retail banks will react as if the banking model has not changed. They will merge in order to strengthen balance sheets and reduce costs, but their market position will have gone. They will have either to completely clean out their existing loan books and significantly reduce banking counterparty risk, to become like the clean corporate banks, or they will be nationalised and suffer a lingering death until they can be privatised as a clean bank again.

The major hindrance to universal/retail banks cleansing their balance sheets is not their toxic assets, as most people imagine, but the systemic risk locked in place by the off balance sheet derivatives contracts that they are party to. Unless the counterparty risks that they are taking in these contracts can be extinguished, they will always be subject to major potential disruptions and credit events caused by the failure of any of their derivative bank counterparties.

The clean corporate banks will in many ways resemble the old building societies, with low leverage levels and stolidly conservative risk outlooks, but with added flexibility and a marginal cost of owning a branch network.

Unfortunately, there are few corporates that will have the necessary mix of attributes to succeed as corporate banks. Only corpo-



Linen Hall
162-168 Linen Hall
London
W1B5TE

T: +44 207 038 3690
F: +44 207 038 3693

www.4-most.co.uk

Author:
Mike Lawrence

rates with household names and multiple convenient outlets will thrive. Those corporates that bought the capital efficiency model which suggested that the most efficient point on the credit curve was around BBB+ will have leveraged themselves too far in the current windowless wholesale markets. The capital efficiency model breaks down when the 'cheap capital' offered by the wholesale debt markets, through put-call parity, is no longer available and debt holders ask for their money back.

Transparency and satisficing investors using limited leverage, is the new black.