The global banking sector: current issues

The financial services sector is emerging from the worst financial crisis for 80 years. Tighter regulation, an overhang of debt in the west and the immense growth in the power of banks in emerging economies will transform the landscape of banking. What opportunities and threats will this create? And what are the main lessons that banks will learn from the crisis?

CIMA sector report
# Key messages

1. There is growing optimism that both the world economy and the banking industry are recovering from the impact of the financial crisis.

2. But the financial world has changed permanently, both in terms of the balance of power within the industry and how banks will be allowed to operate in future.

3. Banks in emerging markets are now well capitalised and well funded and big enough to compete directly against their western counterparts in the global marketplace. They have greater potential for growth because of the relatively immature development of their domestic financial markets and their rapidly growing economies.

4. But regulation will become an issue in the emerging markets just as it is in the more established western markets and may result in a return to more traditional business models.

5. However, the regulatory environment will differ greatly from one country to the next.

6. The stronger role of national governments within banking means the future model for banking and corporate governance is likely to be a hybrid of a regulated free market approach and so-called 'state capitalism'.

7. A key challenge lies in the dichotomy that financial markets are increasingly global while regulators are predominantly national. Greater international co-operation will therefore be needed to improve the stability of the global financial system.

8. The dominant role of the US dollar and of the US banks is set to give way to a world where other countries, their currencies, their capital markets and banks, all play a greatly enhanced role. This structural shift will offer both opportunities and threats.

9. Perhaps the biggest lesson from the crisis is that banks all around the world have learnt that they must co-operate more.

10. The financial crisis has demonstrated the need for banks to understand their business models together with the associated risks and to have confidence that performance indicators and executive incentives reinforce desired behaviours. Through their skills in providing high quality business information, management accountants should be at the forefront of meeting this need and thus contributing to the long-term sustainable success of their organisations.
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Introduction

The global financial system suffered a profound and traumatic shock in September 2008 when US investment bank Lehman Brothers collapsed. As market players withdrew from the financial system, credit dried up and world trade collapsed, there was a real and immediate fear that the world was heading for a repeat of the Great Depression of the 1930s. Two years on and there is growing optimism that both the world economy and the banking industry are recovering from the impact of the financial crisis. But it is equally clear that the financial world has changed permanently, both in terms of who holds the balance of power within global industry and how banks will be allowed to operate in future.

Global shifts in banking

While the growing power of emerging markets is a long-term structural phenomenon, it has accelerated in the banking industry thanks as much to the relative decline of the west as to expansion in the east. There has been a pronounced shift from west to east – and, to some extent, from north to south – in the wake of the crisis. Banks on both sides of the Atlantic are expected to have written down more than $2.1tn of assets by the end of 2010, according to the International Monetary Fund. The equivalent figure for Asian banks is just $115bn.¹ Banks in emerging markets are now well capitalised and well funded and big enough to be able to compete directly against their western counterparts in the global marketplace. The two largest banks by market capitalisation are both Chinese – ICBC and China Construction Bank. Although third place is taken by a British bank, HSBC, it is largely an Asian operation.² A league table, compiled by Bloomberg in April, shows that Citi, once the world’s largest bank, comes in at fifth, while banks from Brazil, Russia and India – the other members of the BRIC grouping alongside China – are all in the top 25.

Stephen Green, Group Chairman of HSBC, referred to this trend just a month after the collapse of Lehman, when he said there was a long-term shift towards Asia and the Middle East. ‘It is this shift that will affect financial markets most profoundly,’ he told a global financial summit in Dubai. ‘The rapid growth of emerging markets does not signal an absolute decline in the economies of mature nations. The pie will grow. But it does entail a loss of share – the developed world will have a smaller share of a larger pie.’³ The rise of China is the most obvious feature of this shift. China’s banking market is dominated by the ‘big four’ state owned commercial banks, of which three are listed on the Shanghai stock market. As well as ICBC, the world’s largest bank, there is Bank of China, the country’s foreign exchange and trade finance bank and China Construction Bank, which specialises in infrastructure projects. The last one and the only one still in full state control is the Agricultural Bank of China, which is gearing up for a flotation in 2010. The key role of the state in investment banking is also evident in India, where three quarters of the banking sector is in government hands. The State Bank of India alone controls about one quarter of the market. The country’s largest private sector bank and second biggest lender is ICICI Bank, which is 23rd in the global table. HDFC Bank is another significant private bank.

But this is not just an Asian story. Brazil has three out of the top 25 global banks: Itaú Unibanco is the pre-eminent private bank and seventh in the global league table, just ahead of rival Bradesco, while state owned Banco do Brasil is 15th. In Russia, the industry is dominated by Sberbank, a state controlled institution that holds a third of the country’s deposits, and by VTB Bank, which is also in government ownership. Singapore, Turkey and South Korea also have banks with market values above $20bn, the cut-off point for the top 25. South Africa – often known as the S in the BRICS – is now a global player thanks to Standard Bank, in which ICBC holds a 20% stake.

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¹ Global Financial Review, International Monetary Fund, April 2010
² A special report on banking in emerging markets, The Economist, 15 May 2010
³ The financial crisis and the shift from West to East, FT/DIFC World Financial Centres Summit, 20 October 2008
Focus on emerging markets

The interesting question is why these emerging market banks were better able to weather what is always described as a global financial crisis better than their US and European counterparts. For many in Asia, the answer is simple, 'there was no financial crisis in India,' says K.R. Muthu Manickam, Vice-President of Finance at HDFC Bank in India. Andrew Lockhart, Head of the Banking and Finance Group at Baker & McKenzie Hong Kong, says Chinese banks were far more insulated than their western counterparts both in terms of direct exposure and in the impact on their share price. 'At the time when there was almost paralysis in the global banking lending market, the Chinese banks were still doing transactions,' he says. These sentiments are echoed in other emerging markets. Alfred Ramosedi, Managing Director of Nedbank Private Bank, part of South Africa's fourth largest bank, says: 'Banks here did not get hit by the financial crisis'. The impact of the credit crunch and on these emerging market banks was largely psychological, with many emerging market banks using the crisis as an opportunity to re-evaluate their growth plans, risk management principles and governance.

Looking ahead, banks in emerging markets have a greater potential for growth because of the relatively immature development of their domestic financial markets. Consultancy firm McKinsey estimates that 2.2 billion out of the 2.5 billion people globally who do not use a bank live in Africa, Asia, Latin America and the Middle East. This offers huge potential for expansion based on innovations such as mobile phone banking and microfinance lending. Bradesco has opened a floating branch on a riverboat on the Amazon river system, the first of its kind in the world, as well as an outlet in Heliópolis, the largest slum in the Brazilian city of São Paulo. As Noel Gordon, a consultant at Accenture, told The Economist, while western banks were 'fiddling with rocket-science finance', emerging market banks were innovating more productively. Even more significant is the rise of the middle class across emerging markets and a consequent increased demand for credit. As wage levels increase in industrialising countries, demand for mortgages and consumer loans for cars and household appliances is likely to increase.

The growth of private banking in South Africa

Alfred Ramosedi, a fellow of CIMA, is managing director of Nedbank Private Bank, part of South Africa's fourth largest bank. He greatly understands the needs of the emerging middle class.

'We target what we call the mass-affluent consumer. The South African market is different from that in the UK. The entry level salary to qualify for private banking here is about R400,000. The end of apartheid in 1994 led to lots of investment and new jobs. This meant that many people were earning higher salaries and starting to generate wealth for the first time in their lives.

Mass-affluent customers want to feel special. They don’t want to wait in a queue like everyone else. They’ve worked hard for their money and they expect to be treated well. People in this market will seek good service above all else, so they expect to get what they pay for or they will make their feelings clear'.

Financial Management, March 2008

Furthermore, emerging market banks are well placed to exploit the marked revival in growth. According to the World Bank, developing countries will enjoy annual economic growth of 6% over the next three years, compared with 2.2-2.6% in the OECD area. As businesses find new market opportunities they will need access to corporate finance, which will open up markets for bond and share issues. Giles Keating, Head of Global Research at Credit Suisse, says some Asian banks, which are already strong and very large but domestic focused, are likely to play a much larger role in intermediating capital flows at the global level. 'If we look ahead five years or so, the total number of major banks operating at scale on a truly global basis may be similar to that of before the crisis, but these banks are likely to be more

4 Counting the world’s unbanked, McKinsey Quarterly, March 2010
5 See 2, previous page
6 Global Economic Prospects, World Bank, June 2010
evenly spread around the world, with the US and Europe no longer so dominant,’ he says. He believes they are likely to be accompanied by rapid growth in a number of second tier banks in emerging markets around the world, active in intermediating flows into their fast growing home markets. Given their strong liquidity and high capital adequacy ratios, some analysts say these emerging market banks are now in a stronger position than their western counterparts. Chinese banks are starting to lend money to European companies for business transactions taking place solely in Europe. ‘Banks in Asia have taken the opportunity to diversify and expand their business in an environment where they have enjoyed a competitive advantage’, says Lockhart.

How management accountants contribute to banking success

The core challenge for banks, as for all organisations, is to create long-term sustainable success. Banks need to understand their business models and have the confidence that these will deliver sustainable value – with appropriate risk mitigations as necessary. They also need to understand the role of performance indicators and executive incentives in driving the right, or wrong, behaviours – as well as how good governance can make a difference. The financial crisis showed that some banks did not grasp these issues adequately.

This is where the management accountant can play a key role. By providing high quality management information, the management accountant supports business success by enabling evidence based decision making as well as effective allocation of resources and robust risk management. For example, the tools and techniques used by management accountants, such as activity based costing help banks to achieve cost leadership. They can also provide information to enhance understanding of customer, product and delivery channel profitability – key issues for retail banks. Management accountants can be compared to navigators - planning the route and providing the information and key performance indicators - to influence the desired outcomes.

Management accountants also have the skills that enable them to progress in all areas of banking, for example, they might work in lending functions where their skills can be applied to credit assessment. Or they might work as business advisors to ensure the long-term success of their customers. This is especially true for the small business sector, which is usually a key engine of growth in many economies – but where financial and business management skills can be patchy. They might also be found in regulatory or risk management functions, undertaking detailed financial analysis. There are many possibilities. For example, Helen Weir, a fellow of CIMA, joined the board of the UK based Lloyds Banking Group as group finance director in 2004 and then moved into a general management role as group executive director, UK Retail Banking in 2008.

Regulation

But as banks in emerging markets expand and enjoy the growth rates that western banks did after World War Two, regulation will become an issue in these markets just as it is in the more established western markets. Banks in the US and Europe suffered immense losses during the crisis, partly as a result of excessive risk taking and investment in complex products that they did not fully understand. Many had to be rescued by national governments, which have amassed historically high fiscal deficits as a result. Nouriel Roubini, the US economist who forecasted the crash, estimates that the US government alone has committed $11trn in the form of recapitalisations, guarantees and insurance, of which $3trn has been drawn on.  

7 Lecture at London School of Economics, 18 May 2010, Author’s note
Governments in the west have made it clear that they want tighter global banking regulation to ensure that such a crisis cannot happen again. Finance ministers of the group of 20 developed and emerging economies have called for: stronger capital and liquidity standards; a ‘fair and substantial’ commitment by banks to pay back the cost of government intervention; and tighter regulation to ensure greater supervision and transparency. According to Deutsche Bank, this new and additional regulation will result in a return to more traditional business models. ‘Banks will be less able to achieve growth and will, hence, on average also be less profitable than previously,’ it said in a research note. The Institute of International Finance (IIF) has calculated that the implementation of full regulatory reform will reduce GDP in the core area of the US, eurozone and Japan by 3% by 2015, while some 9.7 million fewer jobs will be created.

Case study of complexity - Lehman Brothers’ use of Repo 105 transactions

Lehman Brothers, the failed investment bank, stands accused of misleading investors, regulators and other users of their financial statements due to its use of ‘Repo 105’ transactions to temporarily improve its leverage position at financial reporting period ends.

But what are Repo 105 transactions? In simple terms, assets are sold typically just before a reporting period end for 5% less than their current balance sheet value with an agreement to buy them back shortly after the period end for the amount borrowed plus interest. The difference between the cash received and the asset values is known as the ‘haircut’. The cash received is used to either pay down debt or improve the net debt position specifically to make period end figures look better.

As Lehman did not technically have sufficient cash at the period end to repurchase the assets, due to the 5% haircut, then US GAAP regards it as having ‘lost control’ of the assets and requires the assets to be removed from the balance sheet and replaced with the cash. This was the case even though the bank’s own staff regarded Repo 105 as little more than an ‘accounting gimmick’.

According to the Chapter 11 report into the collapse of Lehman Brothers, Repo transactions started to be used by the bank in 2001. By 2007 the amount regularly involved was $25bn but this was soon to ramp up even higher. The first two quarter year ends in 2008 saw Lehman remove $50bn of assets which had the effect of improving the net leverage ratio to 12:1 when the true figure was nearer 14:1.

External reporting of the transactions relied on the rules of US GAAP and with no ‘substance over form’ override there appears to have been no opportunity to question the accounting treatment selected.

There also seems to have been opacity in the internal reporting of these transactions with senior management apparently unaware of the use of Repo 105 transactions to manage balance sheet values. A strong management accounting function producing regular senior management and board reports would have highlighted the fluctuation in leverage at reporting period ends and cast light into the murky corners of accounting at Lehman Brothers.

8 G20 finance ministers’ communiqué, Busan, South Korea, 5 June 2010
9 Global banking trends after the crisis, Deutsche Bank Research, 15 June 2009
10 Interim report on the cumulative impact on the global economy of proposed changes in the banking regulatory framework, IIF, 10 June 2010
11 United States Bankruptcy Court, Southern District of New York In re Lehman Brothers Holdings Inc et al, Debtors, Chapter 11 Case No.08-13555 (JMP) (Jointly Administered) Report of Anton R Valukas, Examiner (www.lehmanreport.jenner.com)
However, it is not clear that the new regulatory regime will affect all parts of the world equally. Regulators in Asia are still very much looking to the west to see how individual banks and governments rewrite the rules of corporate and banking governance in the light of the events of 2007-8. Keating at Credit Suisse says the rules will not be adopted uniformly. ‘As a consequence, the regulatory environment will differ greatly from one country to the next,’ he says.12 Governments in emerging markets in Asia, Africa and Latin America are in a much stronger position as banks in their countries escaped the worst of the crisis. The stronger role of national governments within banking means the future model for banking and corporate governance is likely to be a hybrid of a regulated free market approach and so-called ‘state capitalism’. As Andrew Lockhart of Baker & McKenzie says, in China ‘what we are seeing is pretty active control of the banks, particularly their liquidity ratios, which is being done on a micro-management basis for reasons related to the overall control of the economy as opposed to pure prudential regulations of the financial institutions themselves’.

Banking executives in emerging markets can feel fortunate that their governments did not open up the market too widely before the financial crisis. But given their still very traditional asset portfolio, the desire to understand how to respond to more complicated and complex financial products – the real money makers – is still very strong, and in many instances, government led. The China Banking Regulatory Commission is actively encouraging the development of a stronger China derivatives market. Some may argue that it was these complex financial products that got banks into trouble in the first place, and the development of more complicated and diverse financial products clearly is not without some inherent danger. This will mean that emerging market banks and policymakers will be determined to impose strict rules on banks as their appetite for risk grows to ensure they avoid the west’s mistakes. Edwina Li, Financial Services Partner at KPMG China, says: ‘China’s regulators are always looking to see how they can do it better. In many ways, we’re going to see more regulation’.

Stephen Green of HSBC pointed out in 2008 that as economies became larger and more sophisticated, they would need fully functioning capital markets to ensure the efficient allocation of capital. ‘The main challenge lies in the dichotomy that financial markets – as this crisis has demonstrated – are increasingly global, while the policymakers and regulation that governs them remain predominantly national,’ he said in Dubai. ‘Greater international co-operation will be required to place the financial system on a more stable footing’. More recently William Rhodes, a vice chairman of the IIF and a senior adviser to Citi, said that the introduction of reforms needed to be ‘determined with great care’. He said this was the case not just in the mature industrial countries where it could slow economic recovery, but also in emerging markets ‘where banks are the most important engines of development and growth’. 13

According to the IIF’s own analysis, emerging markets are likely to be less affected by the regulatory reform than their western counterparts, perhaps adding to the shift in the balance of power. It found that most emerging market banking systems were relatively well capitalised and maintained ratios of regulatory capital to risk weighted assets above the current 8% minimum under the Basel II requirements. But the focus of attention in the immediate future will be on western banks because, says Josef Ackerman, Chairman of the boards of both the IIF and Deutsche Bank, they bear the ‘responsibility for contributing to the crisis’.14 He says the onus is on these banks to strengthen their operations and avoid the deterioration of business practices that characterised the period preceding the crisis. While regulation will make banks more cautious, proposals announced both by the US and UK to split up universal banks with both investment and retail functions mean they may become smaller.

12 Financial industry after the crisis, G Keating, Credit Suisse, 6 November 2009
13 Opening press statement, IIF Spring Membership Meeting, Vienna, 10 June 2010
14 See 12, above.
Opportunities for the future

But not all western banks have been left weaker. Spain’s Santander was a regional bank a decade ago but is now the third largest developed country bank. It bought several injured UK banks to add to the Latin American portfolio it has built up. According to Keating, the world is becoming ‘multipolar’ in terms of both economics and politics. ‘This is likely to be clearly reflected in many aspects of the financial system,’ he says. ‘The dominant role of the dollar and of the US banks is set to give way to a world in which the US is still important, but in which other countries, their currencies, their capital markets and their banks, all play a greatly enhanced role. As with all great changes, this structural shift will offer both threats and opportunities for investors’. As western banks go through painful restructuring, tackle the problems with toxic assets and – in the case of nationalised banks – get ready for re-entry into the private sector, emerging market banks are likely to look to each other for Keating’s new opportunities. ICBC’s $5.5bn acquisition of a 20% stake in Standard Bank of South Africa is probably the pre-eminent example. Russia’s Sberbank has a branch in India and Brazil’s Itaú has established a presence in Dubai and Shanghai. In South Africa, FirstRand has entered into a ‘strategic co-operation’ with China Construction Bank focused on growth opportunities in the African continent. And HSBC is looking to acquire a majority stake in Nedbank, South Africa’s fourth largest banking group.

Conclusion

Perhaps then, the biggest lesson from the crisis is that banks all around the world have learnt that they must co-operate more. As Xiao Gang, Chairman of the Bank of China, says: ‘It is not about who should learn from whom. Instead, it is about learning from each other, strengthening co-operation and seeking development together.’ It is this trend – north and south, east and west, rather than north versus south and east versus west – that is likely to shape the future of global banking in the post financial crisis world.

15 Incremental banking reform proved best, China Daily, 22 June 2009
CIMA sector reports

This report is one of a series of six reports all of which examine current issues and trends. Other titles in the series are:

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