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Global Banking - Challenges and Opportunities

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I. ABSTRACT & INTRODUCTION

In modern time there have been huge reductions to the barriers of global competition in the banking industry. Increases in telecommunications and other financial technologies, such as Bloomberg, have allowed banks to extend their reach all over the world, since they no longer have to be near customers to manage both their finances and their risk. The growth in cross-border activities has also increased the demand for banks that can provide various services across borders to different nationalities. However, despite these reductions in barriers and growth in cross-border activities, the banking industry is nowhere near as globalized as some other industries. In the vast majority of nations around globe the market share for foreign owned banks is currently less than a tenth of all market shares for banks in a particular nation. One reason the banking industry has not been fully globalized is that it is more convenient to have local banks provide loans to small business and individuals. On the other hand for large corporations, it is not as important in what nation the bank is in, since the corporation's financial information is available around the globe. In 2008, as the credit crisis broke, banks underwent near-death experiences on a massive scale. Last year, many enjoyed a recovery that was nearly as abrupt. In the intense uncertainty that ensued, bankers around the world have rightly shifted their focus away from growth and toward survival as they confront ambiguity about markets, risk, regulation, and demand.

II. CHALLENGES

1. REGULATORY FRAMEWORK

Each regulatory agency has their own set of rules and regulations to which banks and thrifts must adhere. The Federal Financial Institutions Examination Council (FFIEC) was established in 1979 as a formal inter-agency body empowered to prescribe uniform principles, standards, and report forms for the federal examination of financial institutions. Although the FFIEC has resulted in a greater degree of regulatory consistency between the agencies, the rules and regulations are constantly changing. Under a scenario of lower global economic growth and tough regulatory restrictions, all but emerging-market banking giants will probably destroy value over the next four years. Funding costs will remain high, further hurting profitability. Global Institute (MGI) developed to help model uncertainty about economic recovery and growth. We adapted these scenarios to include the particular forces that most influence banking returns: inflation and the shape of the yield curve, as well as uncertainties about state intervention, including new capital requirements, consumer protection measures, and new rules on risk management, pay caps, and the extension of regulation to the "shadow" banking system.

2. RECESSION

Prolonged recession followed by sub trend growth, returning within two years to pre-crisis rates. Markets in nearly all asset classes would recover as regulators sought to stabilize the financial system, improve risk-management practices, and increase transparency. Moderate regulation of systemically important banks would include pay caps, new rules on exotic products, and tighter capital requirements. The extreme case envisions a moderate recession followed by structurally slower global growth. Markets would remain severely dysfunctional, and regulators would see banks as utilities, not independent agents, and accordingly attempt to limit their returns and to suppress volatility. Strict regulation would be applied not only to systemically important banks but to smaller entities as well. In this scenario, banks would face much tighter capital requirements.

3. DYNAMIC ECONOMIC ENVIRONMENT

The changing economic environment has a significant impact on banks and thrifts as they struggle to effectively manage their interest rate spread in the face of low rates on loans, rate competition for deposits and the general market changes, industry trends and economic fluctuations. It has been a challenge for banks to effectively set their growth strategies with the recent economic market. A rising interest rate environment may seem to help financial institutions, but the effect of the changes on consumers and businesses is not predictable and the challenge remains for banks to grow and effectively manage the spread to generate a return to their shareholders.

4. MANAGEMENT OF ASSETS

The management of the banks' asset portfolios also remains a challenge in today's economic environment. Loans are a bank's primary asset category and when loan quality becomes suspect, the foundation of a bank is shaken to the core. While always an issue for banks, declining asset quality has become a big problem for financial institutions. There are several reasons for this, one of which is the lax attitude some banks have adopted because of the years of "good times." The potential for this is exacerbated by the reduction in the regulatory oversight of banks and in some cases depth of management. Problems are more likely to go undetected, resulting in a significant impact on the bank when they are discovered. In addition, banks, like any business, struggle to cut costs and have consequently eliminated certain expenses, such as adequate employee training programs

5. AGING OWNERSHIP

Across the country, many banks' management teams and board of directors are aging. Banks also face ongoing pressure by shareholders, both public and private, to achieve earnings and growth projections. Regulators place added pressure on banks to manage the various categories of risk. Banking is also an extremely competitive industry. Competing in the financial services industry has become tougher with the entrance of such players as insurance agencies, credit unions, check cashing services, credit card companies, etc.

III. OPPORTUNITIES

1. CAPITAL SHORTAGE

Capital shortage triggered by the crisis and recently addressed through several rounds of massive capital raising will endure and get worse. Our scenarios model both the demand for capital (the amount needed to finance projected asset growth and meet regulatory requirements) and the supply (earnings, less the amount likely to be paid out as dividends). In every case, demand exceeds supply. Capital needs will range from small (investment banks, which have already raised significant amounts and are holding substantial buffers, anticipating regulatory change) to vast (emerging-market giants, which will need to finance their growth). In-between are the universal banks, which will have modestly challenging capital needs in the midpoint scenario and a very challenging problem in the extreme one.

2. CAPITAL RESTRUCTURING

Weighing on returns will be high and rising cost of long-term funding. Several factors are at work here, beginning with a shift in demand. As part of balance sheet restructuring, many banks are cutting back on short-term, unsecured funding (such as commercial paper) and seeking instead to issue longer-dated debt. Demand will also rise as the longer-dated funding currently on banks' books expires and is renewed. On the supply side, government asset-purchase programs—quantitative easing—are already being retired. Finally, the market will see greater competition for funds, not least from governments that must finance their deficits. All this implies that prices for long-term funding will inexorably rise, shaving as much as several percentage points off ROE, depending on the scenario

3. GROWING REVENUES

According to a study conducted by Mc Kinsey, industry revenues would grow by 5 percent annually through 2014; in the extreme case, the industry would eke out much less attractive annual growth of 1 percent. Under either scenario, the emerging-markets giants come out on top. In the midpoint case, the European and US universals and the investment banks would generate middling ROEs well below their pre-crisis levels. If tax were adopted globally and imposed on the banks, the effect would be to reduce their ROEs by 0.7 to 1.2 percentage points.

4. LARGER SCOPE FOR ASIAN BANKS

For the next several years, Asia's economy will continue to grow, as will the influence and power of its banks. Indeed, in these markets, banking is likely to grow much faster even than the broader economy, because so much of the population is "unbanked."1 In both scenarios, all the emerging markets will grow substantially faster than the more mature markets of Europe and North America. The archetypes constitute a form of destiny: emerging-market giants, riding the back of faster GDP growth, will outperform developed-market universals. In many ways, banking is a leveraged bet on the underlying economy. Yet despite that destiny, banks can do a lot about their performance. Within archetypes, differences in performance will be even greater in the future than they are today. The crisis has considerably ratcheted up economic volatility, putting an end to the period some have dubbed "The Great Moderation." This volatility will amplify the existing differences in performance. Even banks that have been dealt a challenging hand can do much to outperform their peers and reward stakeholders.

5. STRATEGIES FOR SUSTAINABILITY

To mitigate these longer-term structural changes, banks can and should take many strategic steps. The necessary moves include reconfiguring and empowering regulatory strategy, placing big bets on the fastest-growing areas, and rethinking liquidity to treat it like other scarce resources the corporate center manages. Such steps, as well as innovations yet unseen, will be important variables in determining the shape of global banking over the long term.

6. EIGHT TRENDS THAT CHANGE THE GLOBAL BANKING SCENARIO

1. Nationalism vs. globalism: limits on the global

banking model

New economic challenges might push many nations to adopt protectionist trade approaches. This would affect the banking industry's ability to enter or exit markets and constrain ownership structures and repatriation of funds.

2. State capitalism: a new force in global banking

Although the exact architecture of global regulation remains a work in progress, state involvement in both the structure and daily operations of the banking industry is inexorably growing. Despite the obstacles of new regulation, this shift will also generate new business models as resource-limited governments welcome partnerships with institutions able to provide ideas, capital and operational skills.

3. Trade flows: opportunity and volatility

Because most trade takes place within regions, global banks will need to leverage the expertise of strong regional partners. Tied to this theme, successful global banks in 2030 will also be known for their high service standards and long-standing client relationships.

4. New markets: the emerging will have emerged

Many markets currently dubbed "emerging" or "growth" markets will have reached maturity. In Asia, Latin America and Africa, a new set of high-growth markets will have taken their place. Global banks will be able to compete in these markets, but they will need to carefully navigate local needs and regulations.

5. Demographics: an older, more urban generation

Demographics will drive the future of banking. Forecasts indicate that global inhabitants will surpass 8 billion by 2030, a population that will be ever more elderly. New banking business models will be needed to serve this aging, and increasingly urban, demographic.

6. Customer relationships: more personal, greater trust

Customers are taking more control of their financial relationships, and this trend is unlikely to change. By 2030, banks will deepen their personal connections with customers via data analysis techniques that might seem fantastic by today's standards.

7. Payments: new markets and new models

Technology is changing the payments segment of the banking industry at an extraordinary rate. Key developments include: Competition from non-bank Payment Service Providers (PSPs) offering services such as mobile banking

Customer demand for quicker, cheaper, anytime/anywhere payments. More transactions managed through exchanges affected by regulation of over-the-counter derivatives. Heightened focus on systemic risk reduction and control due to post-crisis regulations

8. Energy: challenging the old order

Political and environmental factors related to energy production, combined with new technology, will require new financial products. These are likely to encompass financing and fundraising support for large energy projects.

IV. CONCLUSION

The banking industry is at an inflexion point, banks worldwide have been through a period of great change, much of it voluntary. Capital and reserves have been strengthened, leverage reduced, business models narrowed, and compensation practices changed. Despite this, the industry still faces a unique combination of challenges. The quantum of regulation has increased, and rightfully so; but regulation has also become fragmented across different regime. Opportunities also exist, consolidation enables banks with strong brands and solid capital bases to gain market share. Emerging market growth, driven by massive urbanization, will see the middle classes in these countries grow to some 3 billion people. Many of them will become bank customers for the first time. The ageing of the world population will also provide significant opportunities for banks to help societies adapt to these shifting demographic patterns. Major opportunities will arise from the way technology has revolutionized the world's financial markets; for example, 'big data' can transform banks' understanding of their customers.

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