

Banking on 2015

The year 2014 was a painful one that most bankers would prefer to forget rather than remember.

First, it was a year of record fines on banks. At last count, the fines and settlements were over US\$100 billion and still counting. Ignore the fact that more than half the value of fines was for geopolitical “non-compliance with trading with the enemy”, rather than doing bad for customers, the regulators finally exuded power as to who is the boss.

Second, 2014 marked the end of the regulatory debate, when the November G20 Summit in Brisbane endorsed the regulatory deal on Basel III and total loss absorbing capacity (TLAC) that claim to fix too-big-to-fail banks without any need for bailout by public funds. The fight over the content of the regulatory reforms is largely over, but the implementation battle is only beginning.

If there is one forecast one can make with certainty, it is that when they review Basel III outcome by 2019, it will be a hotch-potch of national versions of macro-prudential stability, which everyone claims to be Basel III compliant.

Third, commercial banks are facing the biggest challenge to their business model with the listing of Alibaba.com, an electronic marketplace that was not even licensed as a bank. Founded less than 10 years ago, its market capitalization at US\$250 billion today is larger than JP Morgan. AliPay and ApplePay together threaten to revolutionize payments and also mobile finance, eating into the lunch of traditional retail banking.

Fourth, consolidation of banking is happening even as the industry becomes more concentrated. The globally systemically significant banks are gaining market share through mergers and acquisitions, whilst smaller banks are exiting the business. Since the passing of Gramm-Leach-Bliley Act of 1999, the number of U.S. community banks declined by one-quarter from 8,263 to 6,279.

Fifth, the banks are no longer drivers of credit conditions, thanks to the massive intervention of reserve bank central banks in interest rates, liquidity, risk and duration through quantitative easing (QE). The Fed is trying to withdraw, even as the European Central Bank (ECB) and the Bank of Japan are embarking on major expansion of their balance sheets. Central bank balance sheets have increased by almost US\$1 trillion annually since 2007, bringing their share of global financial assets to US\$24 trillion or 8 per cent of total by the end of 2013.

Two reports by the World Bank and the U.S. Office of Financial Research illustrate the complex challenges faced by banking.

Firstly, the World Bank, a bastion of financial liberal orthodoxy, has finally admitted that the economic thinking behind development should be revamped to take into consideration the three principles of human decision-making – thinking automatically, thinking socially and thinking with mental models. To use an analogy by the World

Bank Development Report¹, ignoring these is like cockpit design to help pilots steer aircraft. In doing so, the gadget-filled cockpit became so complex that pilots were focusing on the indicators, rather than on where the plane was really going. Similarly, those who design ever-complex rules for macro-prudential stability forget that those who rely on airbags for safety have found that airbags could be also killers.

Secondly, the U.S. Office of Financial Research's 2014 Annual Report² highlighted three areas of threats to financial stability. They saw excessive risk-taking during the extended period of low interest rates and low volatility; evidence of brittle markets due to sudden liquidity stops and asset fire sales, and the migration of financial activity to shadow banking where high-impact risks are more difficult to assess because of opacity.

Specifically, QE and low interest rates have suppressed volatility and encouraged the revival of carry-trade. 2014 was marked by nearly three quarters of market exuberance and low volatility, followed by sharp declines in mid-September and October 2014. The sell-off of risky assets, particularly emerging market bonds and equity, indicated that investors were nervous as to fundamentals.

On October 15, the U.S. Treasury market suffered a short sharp spike equivalent to a "flash crash", described as a five standard deviation move. This was partly due to regulatory restrictions on market makers to take positions and high volume trading by algorithmic trading systems.

Consequently, banking systems today face huge policy and regulatory risks on top of market and technology risks. This is also true for banks operating in Asia.

The burden of QE adjustments will fall on emerging market economies (EMEs), because the relationship between advanced market interest rates and risk premia and EME rates and spreads are non-linear. A return to advanced country normal interest rates will cause EME real interest rates to spike, resulting in slower growth. Greater ECB and Bank of Japan intervention would invite more carry trade speculation against EME asset markets and exchange rates. The sharp depreciation of Asian exchange rates in November/December reflected such volatile capital flows.

Market and policy risks are high because liquidity and rates depend largely on central bank policies and on the uneven/uncertain implementation of the agreed regulatory rules, many of which do not necessarily reflect Asian conditions and risks. Because of low rates, portfolio duration has become higher in bonds and loans. The OFR estimated that a 100 basis point rise in Fed rates shock would result in 5.6 per cent loss or US\$212 billion unhedged loss to U.S. bond mutual funds. That would spark-off another round of EME asset sales.

In the meantime, social inequity and consequences of climate change (natural disasters) add to new risks in the form of social protests, geopolitical tension and weather change impact on food security. Furthermore, commodity prices and exports

¹ World Bank. 2015. "[World Development Report 2015: Mind, Society and Behavior.](#)" Washington, DC: World Bank.

² U.S. Office of Financial Research. 2014. "[Office of Financial Research Annual Report 2014.](#)"

are all under pressure due to the slowdown of China and the advanced markets.

All these belie Mark Carney, Chairman of the Financial Stability Board's heroic argument that thanks to regulatory agreement, the banking system "is simpler, safe and fairer."

The only bright lining is the drop in oil prices, which is equivalent to a US\$1 trillion transfer from producers to consumers. This however depends on whether consumers use this transfer to repair their balance sheets or use them for consumption purposes. If the former, further deflation is inevitable.

The world has excess capacity in old industrial production and shortage in new knowledge products and services that are transforming life styles. Asian banks are caught by that creative destruction in both their customer balance sheets and in their own business model facing the invasion of Alipay, ApplePay and Bitcoin models of settlement on top of a regulatory squeeze. Fortunately, Asia remains still the fastest growing region in the world and has the room to adjust to this transformative change.

Nevertheless, midstream in a phase of post-crisis deflation, those who adapt, reform and restructure their operations fastest to the new normal of high volatility and risks will survive. The year 2015 will be another continuous stress test of the survival of the fittest.