

Part 1

Voodoo

While banking and investment banking have delivered strong returns to shareholders in recent years, the recent upheaval in global financial markets has raised uncertainty about their future earnings potential. And, any assessment of the outlook requires a detailed understanding of the recent history of these markets, including the banks' growing reliance on 'voodoo banking' to boost returns.

UNTIL THE LATE 1970S and early 1980s, banking was highly regulated. It was a bit like the world of George Bailey (played by Jimmy Stewart) in *It's A Wonderful Life*. Community banking was the rule. The banker could dip into his 'honeymoon money' to stave off a potential bank run. During this period jokes existed like the '3-6-3' rule; borrow at 3%; lend at 6%; hit the golf course at 3 pm.

Following deregulation, however, banks evolved into complex organisations providing varied financial services. Deregulation brought benefits for the economy (better access to capital and more varied investment opportunities) and the banks (growth and higher profits).

Over the past 15 years, increased competition (within the industry and, increasingly, from non-banking institutions) and the reduction of earnings from the commoditisation of products forced banks to rely on 'voodoo banking' – performance enhancement – to boost returns. A growing focus on risk-adjusted returns (introduced in the early 1990s by JPMorgan and Bankers Trust) changed the 'business model'.

Traditionally banks made loans that tied up their capital for long periods e.g. up to 25–30 years in a mortgage. In the new 'originate to distribute' model,



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banking

banks 'underwrote' loans, 'warehoused' them on balance sheet for a short time and then parcelled them up with other loans and created securities that could be sold to investors ('securitisation'). The banks tied up capital for a short time (until the loans were sold off) and then the same capital could be re-used and the process repeated. Interest earnings over the life of the loan could be discounted back and recognised immediately. Banks increased the 'velocity of capital' – effectively working the same capital harder to increase returns.

In the traditional model, banks earned the net interest rate margin over the life of the loan – 'annuity' income. When loan assets were sold off and the earnings were recognised upfront, banks needed to make new loans to be sold off to maintain earnings. This created pressure on banks to find 'new' borrowers. Initially, creditworthy borrowers without access to credit in the regulated banking environment entered the market. However, over time, banks were forced to 'innovate' to maintain lending volumes.

New markets for borrowing

Banks created substantial new markets for borrowing. These included:

- **Retail clients** – expanding traditional lending (housing and car finance) and developing new credit facilities (credit cards and home equity loans).
- **Private equity** – providing borrowings in leveraged buyouts and sundry other highly leveraged transactions.
- **Hedge funds/ private investors** – providing (often) high levels of debt against the value of assets.

Enhanced revenues (growing volumes and increasing risk) were augmented by increased leverage and adroit capital management. 'Regulatory arbitrage' evolved into a business model.

Banks increasingly also outsourced the origination of the loans to brokers, who were incentivised by large 'upfront' fees.

The expansion in debt provision relied increasingly on quantitative models for assessing risk. It also relied on collateral, i.e. the borrower put up a portion of the price of the asset and agreed to cover any fall in value with additional cash cover.

The model allowed banks to expand the quantum of loans and allowed extension of credit to lower-rated borrowers. Banks did not plan to hold the loan long term and were only exposed to 'underwriting' risk in the period before the loans were sold off. In cases where the loan was collateralised, it was considered that ample protection was provided by the value of the asset and the agreement to 'top up' the collateral where the asset value fell.

Favorable regulatory rules (the capital required was modest), optimistic views of market liquidity and faith in models underpinned this growth in lending.

Banks also increased their trading activities, especially in derivatives and other financial products. Initially, this was targeted at companies and investors seeking to manage financial risk. Over time, there was an increasing focus on creating risk, allowing investors to increase returns and companies to lower

borrowing costs or improve currency rates. As profit margins eroded, banks created increasingly complex and exotic products, usually incorporating derivatives. Derivatives also became a way to provide additional leverage to customers.

The development of hedge funds was especially important. They borrowed money (against securities offered as collateral) and were extensive users of derivatives. They also traded frequently and aggressively boosted volumes. Prime broking services (bundling settlement, clearing, financial and capital raising) emerged as a major source of earnings for some banks.

Increased wealth and sophistication of customers

As wealth and sophistication grew, investors increasingly sought investments other than bank deposits including equities, bonds and investments in mutual funds. Banks created or purchased wealth management businesses (asset managers and private banks) to service this requirement. The clients of the wealth management units were also major purchasers of securities or financial products created by the banks.

Major banks expanded into emerging markets where similar products could be created and sold to a new client base. Global banks had significant advantages in terms of intellectual property and (sometimes) capital resources over local banks. Profit margins in emerging markets were also relatively high.

Banks also increased their own risk taking. While traditionally, banks had taken little or no risk other than credit risk, over time, they increasingly assumed market risk and investment risk. Originally, banks traded financial products primarily as 'agents' standing between two closely matched counterparties. Gradually, banks became principals in order to provide clients with better, more immediate execution and also increase profit margins.

Increased risk taking to generate higher returns

Increased risk taking was also dictated by business contingencies. Advisory mandates (mergers and acquisition; corporate finance work) were conditional on an extension of credit. Banks increasingly 'seeded' or invested in hedge funds to gain preferential access to business.

Clients often sought an 'alignment' of interests requiring banks to take risk positions in transactions. This evolved into the 'principal' business as banks increasingly made high-risk investments in transactions. In some banks, this evolved into a model in which the bank acted purely as 'principal' rolling back the clock to the days of JPMorgan. Banks convinced themselves of the appropriateness of this strategy on the basis that the risks were acceptable (it was their deal after all!), the risk could be always sold off at a price (markets were liquid) and (the real reason) it generated high returns.

Enhanced revenues (growing volumes and increasing risk) were augmented by increased leverage and adroit capital management. 'Regulatory arbitrage' evolved into a business model. Required risk capital was reduced by creating the 'shadow' banking system – a complex network of off balance sheet vehicles and hedge funds. Risk was transferred into the 'unregulated' shadow banking system. The strategies exploited bank capital rules. Some or all of the real risk remained indirectly with the originating bank.

Banks reduced 'real' equity – common shares – by substituting creative hybrid capital instruments that reduced the cost of capital. The structures generally used high income to attract investors, especially retail investors, while disguising the (less obvious) equity price risk. In some cases, banks used these new forms of capital to repurchase shares to boost returns. For example, CitiGroup repurchased US\$12.8 billion of its shares in 2005 and an additional US\$7 billion in 2006.

The cost of higher returns

Banks increasingly 'hollowed out' capital and liquidity reserves – that is, they reduced these to minimum levels. Concepts of 'purchased' capital and 'purchased' liquidity gained in popularity. The theory was that banks did not need to hold equity and cash buffers as these items could always be purchased in the market at a price.

Bank profits in recent history were driven by rapid and large growth in lending, trading revenues and increased risk taking. Banking returns were underwritten by an extremely favourable economic environment (a long period of relatively uninterrupted expansion, low inflation, low interest rates and the 'dividends' from the end of communism and growth in international trade).

Bankers would argue that the source of higher returns was 'innovation'. John Kenneth Galbraith, in *A Short History of Financial Euphoria*, noted that: Financial operations do not lend themselves to innovation. What is recurrently so described and celebrated is, without exception, a small variation on an established design. ... The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version.

Voodoo banking enabled banks to enhance short-term performance but it also involved greater risks that this might affect longer term results. ●

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