Starting a new chapter

WHEN THE ACT HOSTED A LUNCH ON BANKING FUTURES AT THE END OF SEPTEMBER, THE CURRENT STATE OF GLOBAL FINANCIAL MARKETS DOMINATED PROCEEDINGS. **PETER WILLIAMS** SUMMARISES THE THEMES, AND THE INSIGHTS OF AFTER-LUNCH SPEAKER BRIAN MOYNIHAN.

Executive summary

- At this ACT lunch, sponsored by Bank of America, senior members of the treasury and banking professions heard an incisive assessment of the state of the global financial markets from Brian Moynihan, president of global corporate and investment banking at Bank of America.

When gaining access to all the funding a corporate could possibly need was about as taxing as a stroll in the park, the raison d'être of both treasurers and relationship bankers was in some doubt. But with financial markets in seizure, the true worth of the relationship between treasurers and their banking partners has been thrown into sharp relief. Treasurers in financial and risk management functions play a critical part in working with bankers to ensure that their corporations, and therefore the wider economy, are able to function.

One of the lessons that governments and financial regulators have learned during the liquidity and credit crisis that started last year is the importance of talking on a daily basis to the banking sector about where risk lies. The goal is to make sure risk is distributed across the industry, and does not become bottled up in one place.

Alongside the dire lack of confidence in the capital markets, one of the core problems has been ensuring that all institutions had access to liquidity and funding. Yet another first that has resulted from this market dislocation has been the way that banks, encouraged by the authorities, have come together and toiled side by side in an attempt to work through the problems. There was a bid to restore interbank confidence with mutual assurances given that banks would face each other in the market and that they would continue to trade rather than cut each other out. Bank of America is one of the banks that has been at the centre of the financial storm. In the middle of September it purchased Merrill Lynch in a $50bn all-share transaction.

From the banker's perspective the $700bn rescue plan put forward by US treasury secretary Henry Paulson – which was, at the time of the lunch, still under discussion and had not been voted on by US politicians – had to be big to deal with the huge liquidity and stability problems the financial sector was facing.

WHILE GOVERNMENT AND POLICYMAKERS MAY DO THEIR BEST TO AVOID A RECESSION OR SOFTEN THE BLOW, IN THE END THE REAL ECONOMY WILL GO THROUGH THE CYCLE AND CORRECT ITSELF.

INVESTMENT FLOWS While it is easy to get bound up in the immediacy of the liquidity crisis, it is worth reflecting on the overall economic picture that stands behind the current crisis, and which may put the need to find a solution into perspective. Between the US and the UK there are investment flows worth $500bn a year. Traditionally, the two countries have been among the leading nations in terms of largest investment flows (both inward and outward). It is important that the US and the UK continue to trade and continue to invest to help, not only themselves, but the global economy through the current malaise.

But while increased trade has been a hallmark of the past few years, in the financial services sector another trend has been equally apparent. Increasing complexity has become one of the key features of modern capital markets with, until a few months ago, a seemingly unstoppable rise in complex financial instruments such as structured derivatives, structured securitised assets and other products. The idea behind these products was that they would help to fund growth and spread risk and that all would be fine. Problems with these

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instruments first emerged with the US and UK housing crisis unearthing problems in the capital markets and in some of the instruments in which so much trust had been placed. As a result of overleverage, toxic assets and the crash in confidence, the landscape of both Wall Street and the City of London has changed for ever with well-known and seemingly invincible brands going bust or being forced into the arms of bigger and better capitalised rivals. The era of the dominant investment banker appears over.

BLEAK FUTURE While the crisis appears to continue, key questions remain: who will survive, who won't, and how will we know when we have reached the bottom and things will start to get better? In the longer term it will be intriguing to see what the global financial services sector will look like in 2013 or 2018.

In the short term, the outlook for the financial services sector is undeniably bleak. A string of financial services companies across the US and Europe have disappeared, many of them literally overnight. Many of these companies had histories reaching as far back as the 19th century and their failure would have been deemed unthinkable a few months ago. Now, with all the other financial news, they struggle even to make the top story.

Unemployment is also on the rise, tipping over 6% in the US for the first time in five years, with projections claiming the figure is set to rise still further. And while the value of the dollar continues to ebb and flow, generally it is weak.

It is undoubtedly true that until recently developed economies across the globe enjoyed sustained periods of growth and some of that good growth came from good resource deployment, innovation and productivity gains. But that is not the whole story: some of the growth was more akin to a boom, with speculation in assets such as housing. It will take time to sort out the correct value of assets as supported by the real economy as opposed to that element which was driven by speculation. While government and policymakers may do their best to avoid a recession or soften the blow, in the end the real economy will go through the cycle and correct itself.

How deep the US financial crisis is remains to be seen. In the first nine months of 2008 in the US 12 financial services firms failed. Compare that with the crisis between 1986 and 1991 when 2,000 US banking institutions folded. With the years of consolidation and with better – if not perfect – risk management, Wall Street bankers don't think those numbers will be reached again. However, what could become a feature over the next few years is not the bodies or dead banks but the walking wounded: those firms that will muddle through keeping a careful eye on their capital.

CRITICAL CREDIT While many see the underlying economy as remaining fundamentally strong there are pockets of concern such as energy policy which will need to be addressed. But there is still demand in the global economy, a desire to raise living standards for many, and a substantial capital base currently sitting on the side which could help fuel that process.

In the good times it is the responsibility of banks to exercise restraint and good judgement around credit. As bubbles build, all lenders will make mistakes, but it is the extent of those mistakes which are crucial, if not fatal.

However, the fact remains that credit is critical to the growth of individual companies and economies. There is a growing acknowledgement in the financial services industry of the dangers of the over-extension of credit and a determination to work with the industry and regulators to exercise appropriate restraint. Few would deny that the over-extension of credit and the over-borrowing by some customers is at the heart of this present crisis. The paradox which needs to be faced is that credit is at the heart of driving sustainable economic growth but also represents a danger where too much credit can turn boom to bust.

At the moment it seems likely that one response of regulators to the credit crisis will be to ensure that banks hold greater amounts of capital. What other systemic reforms will eventually emerge is more difficult to tell. When the markets stabilise it seems likely that consolidation will become a feature and this has already started. While it seems inevitable that the banking sector will shrink as a result of this crisis, the industry hopes that the firms that emerge will be stronger, more flexible and more responsive.

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