BANKING & SOCIETY

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Remuneration still the big sticking point

Patrick Jenkins says political pressure to lend to small business is at odds with regulators trying to boost capital reserves

Not that long ago, bankers were respectability personified. Fun-loving, maybe not. Risk-hungry, certainly not. Pillars of the community, absolutely.

But the financial crisis made everyone realise the safe old image was an anachronism – and a dangerous one at that. Ever since the crisis peaked a couple of years ago, banks that have not been spending all their time merely trying to stay afloat have been fending off attacks from politicians, regulators and the mass media. They caused the crisis. They cost governments billions in bail-out money. What are they doing to make amends to society?

Perennially top of the to-fix list is the issue of bankers' pay. Over the past decade, a gulf has opened up between high-street bankers who were the paragons of society a few years earlier, and deal-fixers and traders who were rewarded for riding the boom but have not really been punished for the bust. Despite being tarred with the same brush by the general public, the upstanding branch manager – and his or her team of tellers – have just as much reason as the rest of society to feel bitter about the investment bankers.

They raked in the big money in the boom years, motivated by revenue-based bonus structures to take ever greater risks, regardless of the longer-term fall-out, and have continued raking it in ever since. That is partly because a low interest rate environment – vital to prop up economies in the wake of the crisis – has ironically favoured investment banking, but it is also partly an intrinsic byproduct of the capitalist marketplace: one bank cannot afford to cut pay if its rivals do not, for fear of losing its best staff.

There have been attempts at a political and regulatory level to deal with the issue. The UK has gone furthest so far – with the Financial Services Authority imposing restrictions on the structure of bonus payments and the last Labour government imposing a one-off bonus tax. The European Union has followed up with stricter pan-European limitations on the proportion of a bonus that can be paid in no-strings cash. Other big economies have fallen into line with a G20 ruling that a significant chunk of bonuses should be deferred over several years.

There is continued scepticism in many quarters, with critics insistent that it is not the structure of pay that matters but the huge disparity of total remuneration when compared with dogood professions, such as doctors, nurses and teachers. But supporters of the reforms insist that disincentivising short-term profit is key. "There is a real link now between what is ethical and what is risk-adjusted," says Chris Harvey, global head of financial services at Deloitte.

> It's ironic, politicians are saying: 'we think you took on too much risk. But now we want you to lend more'
>
> **Chris Harvey, Deloitte**

Particularly in Europe but also in the US, pay has vied with one other topic for dominance in the debate about the sector's future – the role of banks as facilitators of the global economy. Since the crisis, various governments on both sides of the Atlantic have imposed lending targets on big banks, particularly those that were the recipients of state bailout money. "It's ironic," says Mr Harvey at Deloitte. "Politicians are saying: 'we think you took on too much risk. But now we want you to lend more'."

Such targets tread a fine line between a free market and a managed economy. "Many regulators think socially useful banking is socially engineered banking," says Bob Penn, partner at law firm Allen & Overy.

So far, at least, the banks have sought to hit the targets and when they have not, as happened in the UK last year, there has been no comeback.

The political pressure on the banks to lend more is at odds with the drive by international regulators, supported by those same politicians, to make the banking sector safer by boosting capital and liquid funding reserves. But while many banks remain reluctant to ramp up lending on their own books, there has been a trickle of initiatives aimed at addressing the issue of small business funding through the back door.

In 2009, with profits booming and a public backlash looming, Goldman Sachs diverted $500m of partners' bonus accruals into the Goldman Sachs Gives programme, a charitable venture that has among its aims "creating jobs and economic growth". At the same time, the bank launched a $500m programme to provide loans and grants to small business in New York and Los Angeles.

Last month in the UK, John Varley, Barclays' chief executive, launched a 10-year £1.5bn venture capital fund, on behalf of the British banking industry, to inject equity into small

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Make them pay: protesters still blame bankers and chief executives for causing the financial crisis Getty

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Banks are at the heart of capitalism

History

Justin Baer examines the role the sector has played in the creation of modern business

Engines of happiness: financial institutions such as the US Federal Reserve have been central to the creation of the capitalist system Bloomberg

Two years after the credit crisis overwhelmed the markets and shook the world's confidence in the banking system, the debate over the social utility of financial institutions and their services still rages. Yet while the events of 2008-09 were in many ways unprecedented, today's bank critics and defenders have in some ways simply inherited the same arguments first posed centuries earlier.

Two hundred years before the invention of the credit default swap, when the city of Basel, Switzerland, was known more as the place to sign peace treaties than set capital requirements, the rhetoric over banks' contributions to society was no less passionate.

Thomas Jefferson, the founding father of the US and author of the Declaration of Independence once called lenders "more dangerous than standing armies" and opposed vehemently the creation of a US central bank. Not surprisingly his political rival, Alexander Hamilton, had a different view.

"Most commercial nations have found it necessary to institute banks and they have proved to be the happiest engines that ever were invented for advancing trade," Mr Hamilton, the first US Treasury secretary and founder of the Bank of New York, wrote in 1781. "Venice, Genoa, Hamburg, Holland and England are examples of their utility."

Hamilton was arguing for the creation of a national bank, but his words – as well as those of his rival, Jefferson – could easily apply to the role of commercial and investment banks in creating the modern business world.

In the 19th century, as agrarian economies gave way to the industrial revolution, corporations sprang to life with the help of banks. Companies and individuals no longer relied on barter to conduct business. Cash, so the cliché goes, became king.

"By 1900, there were dozens of industrial corporations," says John Steele Gordon, a business historian and author of *An Empire of Wealth: The Epic History of American Economic Power*. "It was a whole new world. These companies needed huge amounts of capital."

The bankers came of age, too. John Pierpont Morgan and Jacob Schiff, the dominant financiers of the era, provided the capital for Western Union, General Electric, Carnegie Steel and many other industrial heavyweights.

By the early 20th century, stock markets would emerge as significant sources of capital, giving rise to a new class of corporate owners.

"You had more stakeholders involved than ever before," says Charles Geisst, professor of finance at Manhattan College and the author of several books on Wall Street.

Family-run businesses went public and hired professional managers, Mr Geisst said.

When the markets grew overheated and panic ensued in 1907, it was the Morgans and the Schiffs – the US Congress had not yet created the Federal Reserve – who stepped in with capital to shore up the banking system.

The private banks filled that void, but the truth is they had to," Mr Geisst says. "There was not one else to do it."

While the formation of a US central bank would forever change the industry's response to crises, banks continued to play pivotal roles in developing the world's economies.

Depression-era regulations would separate Wall Street – the issuance and trading of securities – from commercial banking – taking deposits and making loans. Until those rules were rewritten decades later, financial institutions from each side of the divide would flourish on their own.

Walter Wriston, who ran Citibank from 1967 to 1984, would help bring automated teller machines to almost hundreds of thousands of street corners. Millions of consumers would come to own credit cards and certificates of deposits.

Epitomised by Lazard's Felix Rohatyn, investment bankers helped corporate chieftains expand dramatically through mergers and acquisitions, creating a new generation of conglomerates that would diversify into markets with little or no connection to their core businesses.

From seeding a burgeoning technology sector and creating a junk-bond market that would finance leveraged-buyouts (and corporate raiders), to the development of the debt-securitisation markets that would create a massive mortgage bubble, banks have been at or near the epicentre of every economic boom or bust of the past century.

Occasionally, bankers did play a more direct role in society, as they did in the 1970s in helping the city of New York restructure its debt to avoid bankruptcy after the US president, Gerald Ford, famously declined to offer federal aid. The cause – one their critics would argue was not entirely selfless – would help burnish Wall Street's reputation in its home town.

"There was great hostility toward New York," says Mr Rohatyn, who led the effort as chairman of the Municipal Assistance Corporation. "Bailing out New York City became a symbol. If the city went bankrupt, that would show that liberalism was a sham."

Bailing out the banks themselves, as the world's governments did in the most recent crisis, was symbolic, too. Whether one believes they are deadlier than hostile forces or "happy engines" of economic growth, few now doubt the financial services industry's importance to the economy.

"The banking industry is the circulatory system of the economy," Mr Gordon says. "It's analogous to the heart. Breaking your arm is unpleasant – it takes awhile to recover but eventually you're as good as new. If your heart fails, you're in trouble."

Pay still the big sticking point

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businesses. Critics said the size of the fund meant it could realistically back only a couple of dozen companies. But bankers defended it as a useful mechanism to put equity into capital-starved businesses, which could then in turn attract bank loans more easily.

In France, Crédit Agricole has prided itself on doing more than most to address the needs of its clients and broader French society amid the current economic difficulties. "Our main role has been to provide credit to the economy," says Joseph d'Auzay, general secretary. "Throughout this period, we have never failed to increase our lending to the economy."

But the approach of the group – which has its roots in a mutually owned network of local lenders based in the farming industry – goes beyond the credit business. Mr d'Auzay is proud of having set up a network of specialist offices to give help to the needy – not just Crédit Agricole customers, but clients of other banks, too. "It's like a private citizens' advice bureau," he says. "We will talk to those going through difficulties and help them get financial assistance, help them work out a family budget and understand how to save."

Mr d'Auzay also mentions a programme to recycle the bank's old stock of computers which, once "thoroughly cleaned" at a specialist processing plant in Tours, in the centre of France, are passed on to the "disenfranchised".

Though perhaps less quirky, there are countless examples of banks engaging with society around them and signing up to corporate social responsibility programmes. Following the crisis they are keener than ever to shout about their good works. Goldman's 10,000 Women programme, which seeks to support female entrepreneurs in 21 emerging economies through business and management education, access to capital and mentoring networks, is one of the most widely acclaimed.

But in their core approach to business, a wholehearted adoption of ethical practices remains on the margin of the industry, with operators such as Triodos Bank in the Netherlands and The Co-operative in the UK among only a few names to sign up to wholesale pledges on lending and investing ethically.

One initiative that may suggest an incursion of the approach into the mainstream, however, was launched recently by emerging markets bank Standard Chartered, with the first of a series of reports on the bank's social and economic impact on the markets in which it operates. Peter Sands, chief executive, said he hoped the first report, on Ghana, would encourage other banks to assess the usefulness of their activities.

"The banking industry needs to be thoughtful about what it is doing," he said at the time of the launch. "You have to think: 'what is this for?'".

New rules will change the game

Basel III

The cost of using derivatives and hedging is set to rise, writes **Brooke Masters**

Banks around the world are having to reassess their business plans and risk choices in the face of a global regulatory rewrite of bank safety and soundness rules that will make some lines of business more expensive and even unprofitable.

The Basel Committee on Banking Supervision, made up of regulators and central bankers from 27 of the largest economies, is still putting the finishing touches on its new rules. But the broad outlines and timetables for "Basel III" are now clear.

All banks will – in effect – be required to hold top quality "tier one capital" equal to 7 per cent of their total assets, adjusted for risk, up from 2 per cent before the financial crisis. Large global banks are likely to have to hold somewhat more, especially if they are based in the UK, US, Switzerland and some Asian jurisdictions.

Over the next nine years, the definition of what counts as tier one capital will narrow sharply, and new rules for risk-weighting will also dramatically increase the amount of capital that banks have to hold against potential losses.

Basel III also includes two new liquidity rules also designed to make banks safer – the liquidity coverage ratio that requires banks to hold enough cash and other easy-to-sell assets to survive a 30 day crisis, and the net stable funding ratio that will force banks to hold more long-term funding. Both of these rules will be phased in more slowly and regulators have promised to adjust them to deal with unforeseen consequences. But bankers, lawyers and regulators agree that the effects on the industry will be profound. Many banks are rushing to hire new experts in risk and compliance to help them comply with the new rules.

"Basel III will impose a complex, detailed set of requirements on banks. Even the operational cost and burden of implementing its mandates cannot be overstated," says Greg Lyons, partner at the law firm Debevoise & Plimpton.

Some critics warn that they will curtail economic growth by making some banking functions, such as lending for working capital and trade finance, far more expensive. Supporters counter that the main effect will be to curtail the use of unnecessarily complex financial products for regulatory arbitrage. Derivatives and structured products will almost certainly become more expensive to use, both in terms of fees and collateral requirements.

"If I were a corporate treasurer, what I would be more worried about is not ordinary borrowing but more funky stuff, derivatives and hedging risk, because that is where corporate treasury proves its worth. The cost goes up in this brave new world," says Bob Penn, partner at law firm Allen & Overy.

Researchers at the International Monetary Fund recently studied 62 of the world's biggest banks to determine the combined impact of the various Basel III rules that tighten the definition of acceptable tier one capital and increase the risk weighting of the assets. Their paper concludes that under the new more rigorous definition the existing average tier one ratio for large banks would fall from 8.6 per cent to 5.8 per cent.

"If banks are going to have to raise more capital, they are going to need a return to pay for that capital, so they will have to look at their pricing. It's unclear where that will hit and it's unclear how big it will be," says Patrick Fell, director of PwC's regulatory capital practice.

The IMF researchers say they believe the far-off 2019 deadline will allow all but 10 of the banks to meet the requirements through retained earnings. But regulators in some countries may not give their banks that much breathing space – the UK and US have talked publicly about pushing up their deadlines.

"The UK emphasis on action risks disadvantaging banks that are headquartered in the UK and is also discouraging many international banks – some of whom are repatriating or relocating all or some of their business. If the UK does go it alone the strength of the regulatory emphasis could affect profits to some degree," says Michael McKee, partner at the law firm DLA Piper.

The liquidity rules will, if anything, be tougher to meet than the new capital requirements, if they are not amended.

The IMF writes that a majority of the European banks cannot meet the net stable funding requirements. The researchers predict that bank funding costs will increase significantly, and that investment banks will have a hard time complying with all the changes.

The net stable funding ratio in particular will force many banks to compete aggressively for new deposits because they are favoured above wholesale funding.That could benefit small and medium sized companies and retail investors through higher interest rates. But some banks may chose to cut back lending or charge more for it.

"Retail deposits are not going to miraculously grow on trees. Unless deleveraging goes a lot faster or unless lending to the personal and SME sectors is cut back, big UK banks are going to remain dependent for some years on wholesale funding," says Michael Foot, chairman of Promontory Financial Group, a regulatory consultancy.

Sign of the times: compliance experts are needed Dreamstime

> Retail deposits are not going to miraculously grow on trees
>
> **Michael Foot**
> **Promontory Financial**

Glass-Steagall solution moves out of favour

Regulation

Megan Murphy on the rise and fall in popularity of a cure for the ills of the banking world

In 1933, after the stock market crash of 1929 ushered in a wave of bank failures, US legislators sought to restore faith in the financial sector by passing the Glass-Steagall Act, which forced banks to separate commercial banking activities from riskier trading and securities activities.

More than 75 years later, and a decade after Glass-Steagall was repealed, politicians, regulators and even some senior bankers were pushing for the reintroduction of similar restrictions in a bid to prevent another global financial crisis.

Separating banks' more pedestrian retail banking operations from their investment banking – or, in the words of some politicians, their "casino" banking arms – has been backed in whole or in part by diverse array of figures, including Paul Volcker, a former Federal Reserve chairman, Vince Cable, the UK's business secretary and Mervyn King, the governor of the Bank of England.

Among voters, many of whom still blame overpaid investment bankers for causing the crisis by pushing complex subprime mortgage-related products they did not fully understand, it is a proposal that also draws widespread support.

In the US, Mr Volcker has already led efforts to introduce a rule in the Dodd-Frank financial reform legislation that bans banks from the short-term trading of securities for their own account, known as "proprietary" trading, and limits their investments in private equity groups and hedge funds.

But those restrictions, known as the "Volcker rule," fall far short of a Glass-Steagall-style enforced separation, and there are early signs that the reforms may be further watered down by a now Republican-led US Congress.

In the UK, far-reaching structural changes are still being discussed by the Independent Commission on Banking, a five-member panel set up by the coalition government in June and chaired by Sir John Vickers, the former chairman of the Office of Fair Trading, the competition watchdog.

Among the eight broad options for reform being considered by the ICB, most attention has centred on a forced break-up of Britain's largest banks, several of whom, such as Barclays, Royal Bank of Scotland and HSBC, have large investment banking operations.

But again, the early indications from people close to the commission's thinking are that it is more likely to recommend less radical changes, such as requiring banks to create "modular" structures that would allow for the failure of a certain business line without bringing down the whole group or forcing them to turn to the taxpayer for support.

Why has the nascent push for a return to Glass-Steagall seemingly faltered?

To be sure, the world's leading "universal" banks – such as JPMorgan Chase, Barclays and Deutsche Bank – have worked hard to convince regulators and the public of the merits of combined groups, where corporate clients have access to a full array of commercial and securities services.

For example, Bob Diamond, the head of Barclays' investment banking operations who is soon to succeed John Varley as chief executive of the group, is fond of citing the need for multinational clients to manage their business risks in different locations across the globe – hedging their currency and interest rate exposures while raising debt and equity to fund their operations from Britain to Brazil.

In the UK in particular, several senior bankers have also suggested that the forced break-up of banking groups would see iconic names such as Barclays and HSBC shifting their operations to New York, Hong Kong or Singapore.

While the coalition government has repeatedly affirmed its intention to "rebalance" Britain's economy, with financial services contributing a lower proportion of national gross domestic product, the loss of several large banking groups would mean a big hit on both corporate and individual tax revenues – in addition to damaging London's standing as an international financial centre.

More fundamentally, figures such as Alistair Darling, the former chancellor of the exchequer, have put forward the argument that separating retail from investment banking will not prevent another shock to the financial system.

Of the banks that failed during the crisis, Lehman Brothers and Bear Stearns were "pure-play" investment banks, with no retail operations, while Northern Rock was a relatively small UK mortgage lender without any investment banking activities.

Most senior bankers believe that, two years on from the height of the financial crisis and with the world's attention now focused on a deepening debt crisis in Ireland, the moment for another Glass-Steagall has passed.

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Households and small business still face stagnation

Lending

Demand is likely to remain subdued for some time to come, writes **Sharlene Goff**

Of all the criticism fired at the banks since the financial crisis the biggest public and political storm has been sparked by the accusation that they are unwilling to lend to households and small businesses.

Governments around the world have been forced to intervene to ensure banks are making loans available to viable customers, following widespread concerns that many institutions have prioritised rebuilding their balance sheets and reducing risk over new lending.

Politicians across Europe have demanded that banks sign up to formal lending targets as a condition of the state aid they received during the financial crisis. Meanwhile governments and central banks have provided hundreds of billions of pounds of cheap funding to ease the flow of credit to individual and corporate customers.

And in a clear sign that the debate over lending is unlikely to die down soon, the incoming chief executive of Lloyds Banking Group, the UK bank that is 41 per cent owned by the taxpayer, has agreed the unusual condition of having his bonus in part pinned to small business lending.

Overall lending growth is essentially zero, says Vicki Redwood, from Capital Economics

For their part, the banks say they are taking drastic steps to drum up new business and are approving a high number of new loans. This month Royal Bank of Scotland, one of the UK's biggest lenders, said new lending to businesses in the three months to September was up more than a third year-on-year, while new mortgage lending was also strong. Other European banks have also started to make more credit available after a sharp contraction in 2009.

The problem is that no matter how much new lending the banks do, customers seem to be repaying an even higher amount. Analysts say that businesses have shied away from investing in the recession, while existing mortgage holders, who have benefited from a sharp fall in interest rates, have taken the opportunity to repay bigger chunks of their loans.

But while demand is likely to remain subdued for some time, there is early evidence that conditions are starting to improve.

Economists at Capital Economics say the acute contraction in lending in the UK, US and across much of the Eurozone is abating and there are now signs of improvements in all three areas. Some of the most positive trends have been seen in the eurozone. Recent data from the European Central Bank showed lending to households in September rose about 3 per cent year-on-year, driven principally by a pick-up in new mortgage lending.

Also, while business lending is still marginally down on last year, the picture has improved from six months ago: "There are signs that things are turning around in the eurozone," says Ben May, a European economist at Capital Economics. "While lending is still weak by historic standards, it is certainly stronger than it has been."

However, while the general trend is brighter, there are still a number of weak spots across Europe – Spain and Ireland, for example – where banks are struggling to control bad loans.

The recovery is happening more slowly in the US and UK, where lending has fallen more sharply but there are still some signs of stabilisation. The latest quarterly report from the Bank of England showed that credit became easier to access for UK small businesses in the third quarter, while net lending to businesses and households increased slightly in August.

"There are some signs of improvement but the general picture is still weak," says Vicky Redwood, who covers the UK at Capital. "Overall lending growth is essentially zero and there are a number of factors that could be a drag for some years to come."

One big constraint on banks' ability to lend is that they are having to build up greater capital buffers to protect themselves against the risk of another downturn. Analysts say this could force them to rein in lending, particularly on riskier loans, such as mortgages with high loan-to-values or those to start-up businesses.

Mortgage borrowers are already having to stump up large deposits and meet tougher criteria, meaning that while mortgage rates may be low by historical standards, they are still out of reach for many customers. Banks are also having to wean themselves off the cheaper funding they have received from governments throughout the financial crisis. To make matters worse these issues are set in the broader context of a stumbling economic recovery. There are renewed concerns about the property market, as – for instance – house prices in the UK come under further pressure. Meanwhile fears are growing that the US property downturn could be more prolonged than expected after problems were identified in banks' foreclosure proceedings.

Analysts fear that while the worst of the credit crunch is over, lending growth is unlikely to pick up pace any time soon.

"Hopefully lending won't deteriorate significantly from here," says Ms Redwood. "However the pressures on banks combined with the general economic uncertainty means lending could be stagnant for years."

Yes they can: Goldman Sachs traders watch a broadcast of President Obama criticising financial industry efforts to fight his plan to impose tougher rules on the market Bloomberg

Banks intensify charm offensive as the public furore subsides

Politics

Justin Baer explores how institutions have weathered voter anger and now seek to water down regulations

The worst of the financial crisis, and the destruction left in its wake, was still a vivid memory when a gaggle of bank chief executives arrived in Washington for a late March 2009 meeting with Barack Obama, US president.

"My administration," the president said, according to Politico, "is the only thing standing between you and the pitchforks."

Indeed, the public furore was just beginning for the banking industry even if, history would show, profits would soon return. The next 19 months would find many of the world's biggest banks pay back their bail-out debts to governments, rein in compensation and withdraw from many riskier activities that had left Wall Street in disarray in the first place.

Landmark US legislation would work its way through Congress, culminating with a measure that left few financial services business unchanged. The international Basel committee would unveil new capital requirements designed to protect the financial system from future risks.

A UK tax on bank employees' bonuses trimmed billions of dollars from the industry's profits. And this year, the European Union set rules that forced lenders to defer bonuses and limit cash pay-outs.

Along the way, bank executives had little choice but to grit their teeth as politicians took turns assailing the industry for mistakes that left the credit markets on the brink of collapse.

Two years on from the fall of Lehman Brothers and Washington Mutual and the massive bail-out of American International Group, large banks have sensed the intensity of anti-Wall Street rhetoric at last begin to subside.

Time, along with a midterm US election that saw Republicans regain control of the House of Representatives, has given the industry an opportunity to re-engage on the hundreds of yet-unresolved new rules now in the hands of regulators.

"During the legislative phase of financial regulatory reform, we all listened to and witnessed a lot of misinformation, heated rhetoric and anger," says John Taft, chief executive of the US asset-management arm of Royal Bank of Canada and the incoming chairman of the Securities and Financial Markets Association.

"Now we've moved from a hot medium to a cold one. From rhetoric to analysis. From emotion to fact. From political theatre to operating realities."

The industry has wasted little time in seeking to exploit this evolution. Josef Ackermann, chief executive of Deutsche Bank and head of the International Institute of Finance, warned that the new wave of financial-services industry reforms, including those imposed by the Basel committee, would damage the global economy's fragile recovery.

> The pitchforks have been put aside but the industry's profits may still be under siege

"There can be no doubt that reforms will produce a drag on economic recovery, and this means jobs that should be created and need to be created may not be created," Mr Ackermann said during a recent International Monetary Fund summit.

Meantime Goldman Sachs, which became a lightning rod for Wall Street critics in spite of its healthy emergence from the crisis, launched the biggest advertising campaign in the bank's history in September.

The ads, which appeared in large US newspapers and websites, seek to explain Goldman's role in raising capital for growing companies – a facet of its business largely overlooked by the public when the bank faced charges from the Securities and Exchange Commission for misleading investors.

And in recent weeks, Sifma and other industry lobbyists have made a more overt push to shape the direction of some of the more controversial aspects of the US reform legislation, including a provision that bans large institutions from engaging in so-called proprietary trading.

They have found some allies in Congress to support their positions. In a letter to the Financial Stability Oversight Council, the Republican congressman who may soon chair the House financial-services committee warned regulators that the ban could weaken US banks and drain the markets of liquidity.

The Volcker rule, named for the former Federal Reserve chairman who proposed it, will "impose substantial costs on the American economy and market participants", Spencer Bacchus wrote. "Depending on how US regulators choose to implement it, the Volcker rule may spark a mass exodus of clients from US banks to banks based abroad."

There may be more speed bumps ahead.

The end of the year will bring another wave of announcements on banker pay. Many large institutions have altered policies to pay out a larger portion of compensation in stock and give them the right to "claw back" bonuses should the value of employees' trades decline. But there is little chance multimillion-dollar pay-outs to top executives will not once again draw the ire of the industry's critics.

What is more, the regulators charged with creating the specific rules enacted by legislation may ignore the banks' charm offensive and impose stricter guidelines on issues ranging from capital and derivatives clearing to trading.

The pitchforks have been put aside but the industry's profits may still be under siege.

It's the return of the old-fashioned bank manager

Retail

The sector is striving to win back the trust of customers, writes **Sharlene Goff**

When a new bank sprang up on the UK high-street this year, some observers were surprised to discover it was offering little in the way of a financial incentive to attract customers.

Instead Metro Bank, which is credited as being the first new bank to set up in the UK for more than 100 years, tried to draw mortgage and savings customers away from its bigger rivals by promising a higher level of service.

Its decision is indicative of a broader shift in the retail banking landscape taking place not just in Britain but across the world.

After a period in which banks have increasingly moved a chunk of their operations overseas to cut costs and have put more weight behind their online businesses, many are now performing something of an about turn.

Consultants say that while offshore call centres can be effective at dealing with banks' own technical issues, or basic queries from account holders, they have fallen down when it comes to dealing with the more personal or complex issues customers might have.

Banks across the UK, Europe and the US are now bringing service centres back into their local markets and investing heavily in their branch networks. More significantly, many are attempting to restore their battered reputations by putting customer satisfaction at the heart of their business.

"To a degree we are seeing banks go back to the future," says David Sayer, global head of retail banking at KPMG, the accountancy firm. "They are focusing on their reputation for customer satisfaction and are returning to the old fashioned model of having personal bank managers rather than call centres."

A number of international banks – including Barclays in the UK, BNP Paribas in France and Germany's Deutsche Bank – are giving their somewhat tired branch networks a facelift to improve the experience for customers. West Pac, the Australian bank has launched a campaign to "bring back the branch".

Banks around the world have also launched marketing campaigns that highlight their customer service – a striking difference to the boom years when the focus was clearly on offering the best price to customers.

NatWest, the retail banking arm of Royal Bank of Scotland, the UK government-backed bank, has set itself the target of becoming "Britain's most helpful bank". Its pledges include extending opening hours in its busiest branches and serving customers within five minutes.

Meanwhile Handelsbanken, the Swedish bank, has expanded rapidly across Europe by offering a more traditional banking service. The bank's branches are run independently by experienced local managers who have the power to make lending decisions, rather than having to refer customers to invisible processing centres.

This shift in strategy in part reflects the need by banks to win back customers' trust, which has been severely undermined during the financial crisis.

> 'To a degree we are seeing banks go back to the future'
>
> David Sayer, global head of retail banking at KPMG

Governments around the world have had to step in to prevent what would have been some catastrophic failures of some of the world's biggest financial institutions. Two years later, banks still have not shaken off the blame for causing a downturn that has pushed millions of people into unemployment.

At the same time bank customers have become frustrated at having their calls transferred to – at times – inexperienced staff in offshore call centres, often in India. But as well as the softer issue of rebuilding trust, banks are well aware that they need to adopt a different kind of business model if they are to succeed in the post-crisis world.

While during the boom years, they were able to drive profits by rapidly accelerating lending with little consideration of risk, many are now having to find more sustainable sources of growth.

Consultants say their aim is not just to attract new customers through the door but to retain them for longer with a view to selling them more products. To do this the banks need to have more information about each customer and ensure they are keeping them happy by ticking the right boxes on service.

"If the model works it is a win-win for the banks," adds Mr Sayer.

Many institutions have also found that a branch network is key to having the face-to-face time with customers to sell them other products.

"Existing banks recognise the importance of branch networks for particular products such as mortgages and are having to up their game in order to compete with competitors who are making this a priority," says Neil Tomlinson, retail banking partner at Deloitte.

However, for banks the strategy of staking their reputation on customer service is not without its risks.

Crucially, consultants say they have to be sure they can match the expectations they are creating.

"Banks have to be careful how they portray the restoration of branch managers in adverts as customers will be disappointed if in reality they see someone who is not as experienced or senior," says Mr Sayer.

New ideas: Metro Bank is focusing on service not price AFP

Banking & Society

India considers rate cap on loans to poor

Microfinance

Relying on specialised local institutions has backfired for banks, says **Amy Kazmin**

In India, commercial banks, both public and private, are required to direct a large chunk of their net credit to designated "priority sectors" seen as having a positive impact on India's economy, and wider society – to ensure funds flow into areas the government deems important, but might otherwise be neglected.

These sectors – designated by the Reserve Bank of India – currently include broad areas of agriculture, small scale industries, small business, housing, education and lending to the poor and vulnerable – all areas that could otherwise find it tough to access credit.

Banks traditionally struggled to fill these priority sector lending requirements – 40 per cent of net credit for local banks, and 32 per cent for foreign banks – especially to meet the minimum thresholds for loans to agriculture and the poor, or "weaker sections", as they are quaintly called in official jargon. Failure to meet the targets meant that banks had to buy low-interest bonds from the government's National Bank for Agriculture and Rural Development to make up the shortfall.

But in recent years, India's commercial banks have been turning to specialised microfinance institutions such as SKS Microfinance, a publicly listed company, Spandana, Share Microfin, Basix, Asmitha, and others to meet their obligations to push out credit to the "unbankable" poor in remote rural areas, or urban areas.

Together, Indian banks – including public sector forces such as the State Bank of India, private domestic banks such as ICICI and HDFC, and foreign banks such as Standard Chartered and Citibank – now have around $6bn in outstanding loans to the country's 44 for-profit oriented microfinance companies.

Under pressure: microfinance companies face restrictions on what they charge borrowers such as Sharda Bhandare who makes gloves in the Dharavi slum of Mumbai Bloomberg

With field staff travelling into remote rural areas, these dedicated microfinance operations – most of which began as non-profit, non-governmental organisations before transforming themselves into for-profit companies – have served as the "last mile link" that pushed commercial banks' money onwards to about 30m hard-to-reach borrowers.

"The actual risk assessment, collections and implementing was outsourced to the microfinance institutions," says Jahangir Aziz, chief economist in India for JPMorgan. "It was relatively cheap, relatively easy and far less cumbersome than doing it directly."

Initially, the arrangement suited everybody. Microfinance companies, which were prohibited from taking deposits, needed liquidity to make the millions of tiny loans they claimed would allow poor borrowers to start micro-enterprises and lift themselves from poverty. The banks, meanwhile, could fulfil priority lending targets with loans to a handful of large microfinance companies, rather than trying to establish rural network lending themselves.

That mutually beneficial relationship helped fuel a surge in micro-lending, with the industry's outstanding loan portfolio growing at a blistering pace of 70 to 100 per cent a year for the past five years. But today, microfinance institutions are under serious regulatory pressure, grappling with a backlash against what policymakers and critics are calling their "usurious interest rates" and "coercive" debt collection tactics.

> 'The belief is that if the banks are able to go direct, they can lend at lower rates, and that over time is a more stable system'
>
> **Alok Prasad**
> **MIN chief executive**

What regulators have cast a disapproving eye on is the spread between the rates at which microfinance companies borrow from commercial banks – usually between 11 and 15 per cent – and the nearly 30 per cent rate at which they lend.

Simmering official dismay reached boiling point in August when SKS, India's largest microlender, raised $350m in an initial public offering that valued the business at $1.5bn – and focused attention on the fortunes being amassed in a sector ostensibly dedicated to public well being.

A month later, Pranab Mukherjee, India's finance minister, wrote to Indian state-owned banks, asking them to consider a covenant in future loan agreements with microfinance institutions, mandating that interest rates be capped at 24 per cent.

The RBI also debated whether to remove microfinance from the approved forms of priority sector lending, citing concerns about high interest rates and over-lending, with companies extending loans to the same borrowers, paying little heed to their repayment capacity.

Yet the situation erupted into a full-blown crisis in October, after a spate of suicides among heavily-indebted micro-borrowers in the southern state of Andhra Pradesh – a hotbed of micro-lending. In a hurried Cabinet meeting, the state government adopted an emergency ordinance last month that brought collections to an abrupt halt.

Besides putting the banks' portfolio at risk, regulation has raised questions about whether microfinance companies will be able to operate, raising questions about to what extent they will be able to serve as the "last mile link" for banks.

"At a big picture level, the RBI and the government in its way have been trying to tell the banks to go direct," says Alok Prasad, former India country director of the Citi Microfinance Group, and now the chief executive officer of the Microfinance Institutions Network (MIN), a body representing 44 for-profit MFIs. "The belief is that if the banks are able to go direct, they can lend at lower rates, and that over time is fundamentally a more stable system," he says. "But going from past experience, the banks seem to lack the DNA to achieve that."

It remains to be seen how the whole crisis will play out. The MIN has said its members would cap interest rates in Andhra Pradesh at 24 per cent, a move it hopes will persuade authorities to allow companies back to doing business and collecting outstanding debt.

Meanwhile, the RBI has established a committee to look in depth at the practices of microfinance industry, and recommend a possible regulatory framework. But it could take months until the political and regulatory uncertainty is cleared up, during which time many banks may be reluctant to extend further credit to the sector.

"The form in which microfinance institutions will survive will be very, very different than what they are right now," says JPMorgan's Mr Aziz. For now, though, "banks are back into this problem of trying to meet priority sector lending requirements again".

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Charity is about more than handing over a big cheque

Philanthropy

Sharlene Goff examines how banks are trying to do more than make cash donations

Banks around the world are seeking new ways to engage with charities as they look to maximise the value of their community work in these straitened economic times. Rather than simply handing over large financial donations to their chosen charitable organisations, banks are increasingly encouraging employees to give up their time through voluntary work and are seeking to involve customers in fund-raising schemes.

Stepping up their involvement with charities is one way banks can show they are keen to give something back to society in the wake of a financial crisis they are largely blamed for starting.

But institutions are aware they have to tread carefully when it comes to rebuilding their reputations. Having benefited from hundreds of billions of pounds of taxpayer funds, some believe it may not be appropriate to be seen giving large sums of money to charity. Banks also do not want to be open to accusations of tokenism from a public that is yet to regain its trust in the financial sector.

"We don't just want to do philanthropy – we don't think that's best for our customers or our shareholders," says Sharon McDowall, head of community investment at Royal Bank of Scotland, the UK bank that is 84 per cent owned by the government. "If shareholders – who include the UK taxpayer in our case – want to make a donation to charity that should be their decision."

Most banks – like many big companies – will match any donations employees make to their chosen charities up to a certain amount per month. But when it comes to the charity work they initiate themselves, rather than simply siphoning off a portion of their profits for donations, banks, particularly those that have been kept afloat by government aid, increasingly want a more hands-on role.

More are trying to engage their employees in charitable work by offering them one or two days extra leave per year to dedicate to fund-raising or helping local communities. Some banks are also using fund-raising projects for team-building exercises for groups of employees. "It's right that we're in the community, but we need to add strategic value through the work we are doing. We do this by focusing on the areas where we can make the most difference for the communities we operate in and our business," explains Ms McDowall.

RBS staff gave 155,000 volunteering hours last year and are expected to exceed that number this year. A similar trend has also been seen across Europe – at Deutsche Bank, the German bank, 14 per cent of staff took part in volunteering schemes last year, up from 12 per cent in 2008.

Bank staff are typically encouraged to make use of their professional skills by spending their time mentoring small businesses or helping improve financial education, for example.

Standard Chartered, which, as a British bank focused on developing nations, principally Asia, Africa and the Middle East, recognises that it has a particular responsibility to local communities, also offers a similar scheme to employees. Each member of staff is entitled to two days' paid leave each year to work on one of the bank's charitable projects, or to pursue their own voluntary work.

> Some top bankers gave their bonuses to charity as they sought to calm the public outcry over excessive pay

The focus for StanChart is picking up on the key issues that are affecting local communities. Helping mitigate the effects of climate change is a priority, for example, and the bank also has three of its own charitable projects – one that provides eye care products to developing countries to help tackle avoidable blindness; another that educates people living with HIV/Aids; and a third that seeks to empower young women in underprivileged areas.

Far-sighted: StanChart helps reduce blindness in Nepal

These kinds of employee schemes have the double benefit of not only benefiting the bank's reputation but also creating a more positive working environment for staff.

While during the boom years some banks had an almost blinkered focus on driving profits, many are now switching to a more sustainable business model – and engaging staff in volunteer schemes is part of that.

Other banks – such as Santander of Spain – have also tried to involve customers' in charity projects by asking them to vote on which organisations should receive its support. While these kinds of schemes are intended to show a more long-term commitment to charitable giving, banks have also reacted to the financial crisis by making some eye-catching short-term commitments.

Some of the world's top bankers, including Michael Geoghegan, the outgoing chief executive of HSBC and Peter Sands, head of Standard Chartered, donated multi-million pound bonuses to charity this year as they sought to calm the public outcry over excessive pay. Similarly Goldman Sachs, the Wall Street investment bank, considered forcing senior bankers to donate a portion of their earnings to charity.

These actions were welcome in a year when big value donations – those worth £1m or more – have fallen sharply as a result of the recession.

The row over big bonuses is likely to turn even more sour this time around as western economies come to terms with the effects of unprecedented spending cuts. But while charities may again be hoping to receive big one-off donations from image-conscious bankers, the banks themselves believe the real benefit will come from the more hands-on projects with which their staff are increasingly involved.