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UK Bank Capital
Cyclical recovery or secular attrition?

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UK Bank Capital
Cyclical recovery or secular attrition?

For the first event in *GlobalCapital*'s new GC Live series of editorially led, topical discussions on capital markets, we gathered a select group of UK bank treasurers, bank capital investors, investment bankers and other market participants in London in early December to discuss what conclusions to draw from a tumultuous year for the banking sector.

Banks generally have been enjoying the new world of higher interest rates and an economy that almost seems to have got away with a soft landing. But risk was lurking below the surface, and in March it burst out, with the sudden failure of Silicon Valley Bank and then the tottering of Credit Suisse, which forced the Swiss authorities to make UBS rescue it.

In our first panel discussion, edited and published here, treasurers from Barclays, NatWest and Nationwide and a debt capital markets specialist from Deutsche Bank trade views on whether the March shock showed weakness in the current banking system and regulatory structure, or strength.

Some classic banking risks had been ignored, such as the build-up of interest rate risk in US regional banks. Perils such as deposit runs may have been sharpened by social media and moving money at the touch of a screen.

Credit Suisse's failure, though it complied with regulatory requirements, showed that these do not make the system impregnable — but then, the system is not supposed to prevent all bank failures. That a global bank could fail, without causing contagion across the market, arguably showed that, even if not perfect, the system did its job.

Participants

Moderator: **Toby Fildes**, managing director, *GlobalCapital*	**Daniel Fairclough**, group treasurer, Barclays	**Donal Quaid**, treasurer, NatWest Group	**Rob Collins**, deputy treasurer, Nationwide Building Society	**Josh Benson**, director, UK FIG debt capital markets, Deutsche Bank

Toby Fildes, GlobalCapital: It's been quite a year for banks and bank capital following what happened to Credit Suisse and SVB. It's been at times crazy, stressful, surprising, incredible — perhaps all of these things at the same time on certain days. It certainly hasn't been boring. I wonder whether my panellists agree and what new can be learnt from the bank stress of spring 2023.

Daniel Fairclough, Barclays: We learnt some old lessons as well. One of them is called interest rate risk management that we maybe forgot for a while. We've also learnt about the speed of transmission, particularly deposits, influenced through social media. Clearly that was a new development.

And the other takeaway was regulators had been talking a lot about using buffers, liquidity, or capital. And what really resonated for me was that market confidence and market discipline was critical and trumped this. Very few of those institutions got to use their buffers because the market had a problem with them before that could happen.

Toby Fildes, GC: We'll probably go into whether those buffers and things are fit for purpose in a minute, but Donal what are your thoughts?

Donal Quaid, NatWest Group: I'd echo what Dan said. Most of the learnings were probably what we knew already but haven't witnessed for a number of years: basic shortcomings in risk management — we talked about risk in the banking book, liquidity management; unsustainable business models; the gap in regulation and supervision, particularly in the US in terms of the smaller banks. So, stuff that we knew but probably hadn't witnessed for years.

"The fact that we had Credit Suisse in the situation that it got into and we're all here six months later without the markets having been materially disturbed is a major triumph for regulation."

Daniel Fairclough, Barclays

I agree with Dan, that the speed and depth of liquidity runs in a world of advanced technology and social media is probably the biggest change that we've seen over the last 10 or 15 years.

Toby Fildes, GC: Rob, you were sitting here in December; this all happened in March. You're turning off the bedside light at night, what are you thinking? Do you know what, six months on, we know this now. Is there anything like that at the moment?

Rob Collins, Nationwide Building Society: The thing that Dan touched on first of all is reopening eyes on depositor behaviour. And that speed of transmission, that's certainly an increasing regulatory focus. Do people really know what their outflows in the digital world might look like?

The two things I think about from that period, and they've been oft repeated now, but the warnings signs, the canary in the coalmine, were there if one cared to look. And if you're involved in these areas of our industry, if you had read the ratings reports, you could have got some clues around SVB. But clearly that wasn't the case for all.

And then to quote UBS chairman on "read the docs", that's a slightly facetious comment of course but points to central banks having powers that they can exercise in certain circumstances and that's still something to be wary of.

Toby Fildes, GC: That also shows the danger of assumptions as well. Josh?

Josh Benson, Deutsche Bank: I'm going to take a bit more of a positive stance on this. It was an incredibly volatile moment and, speaking for Europe itself, the contagion impact was quite limited. The positive is the way the market regained confidence quite quickly. That is one of the key takeaways for me.

Toby Fildes, GC: Perhaps the obvious question next is: is the current bank regulation and supervision regime fit for purpose? And if so, why did Credit Suisse go down when it was well-capitalised and meeting regulatory requirements? Rob?

Rob Collins, Nationwide: Confidence has already been mentioned. It only takes a little thing for the domino effect to flow through. So that's the main one — we all know our industry is about confidence, whether at a global wholesale level or whether it's about individual retail deposits. So again, we're reminded that it's all about confidence and if something doesn't look quite right, then people will vote with their feet.

But equally, as we've seen in the AT1 space, memories are quite short as well. People see the yield and get over the concerns they had only a few months ago. So, being quick to recover is another point to be made.

Toby Fildes, GC: A good thing but also potentially dangerous.

Daniel Fairclough, Barclays: European regulators have maybe been given an excessively hard time over what happened. The fact that we had Credit Suisse in the situation that it got into and we're all here six months later without the markets having been materially disturbed is a major triumph for regulation. Crisis management, resolution co-ordination, having the tools available, all of that is a real positive.

Toby Fildes: Crisis is always good six months in the rear mirror. It didn't feel like that in March, though.

Daniel Fairclough, Barclays: It didn't feel like that in March but the contagion effect, as we've said, was relatively contained. And if you'd have said three months previously, you're going to have a G-SIB rescued over a weekend, what do we think the long lasting impact will be, we'd have been much more worried about it.

Josh Benson, Deutsche: The first financial crisis after the GFC was always going to be a volatile period. So, as I said, the rate at which it returned to normality — I think Dan's right, we have to take the positives and European regulators have done their job in that regard. They've protected the system; their job is not to prop up a bank which has potential governance issues, but it's to protect the system and make sure it protects the taxpayer and that is positive.

Donal Quaid, NatWest: I'd add, to your specific question, the regulatory regime was not set up for zero bank failures and it shouldn't be set up for zero bank failures, as that would lead to banks holding ridiculous amounts of capital and liquidity and it would just become an unprofitable business. So, the success is that there hasn't been systemic contagion across the globe, with the regional bank failures in the US and one large G-SIB in Europe.

Toby Fildes, GC: Josh, you mentioned taking the positives. Did it surprise you that it's come back very well?

Josh Benson, Deutsche: Yes and no. If you look at bank fundamentals and the capital stock that's been built up in the last few years, those that work close to the industry were pretty confident that it was going to pull through. At the time you had a lot of retail investors in the bank stock market because of the [perceived] low value of the sector and they jumped at the first sight of this, which had initial impact.

But from the credit standpoint, I didn't see any issues as to why it wouldn't come back soon and I think we, as bankers, thought that the first deals that came out after the crisis would go pretty well.

Toby Fildes, GC: Perhaps crowned by UBS, would you say?

Josh Benson, Deutsche: The AT1? Investors were waiting for that deal to come, for sure. It was a well-documented transaction. There were definitely investors that had kept their powder dry for that transaction. But yes, that was a great transaction. Dan's AT1 was pretty special as well. So, all those AT1s that have happened in the meantime have gone very well.

Toby Fildes, GC: Dan, you mentioned interest rates, but are adequate measures in place to compel banks to hedge interest rate risk?

Daniel Fairclough, Barclays: For me, this is a real transatlantic divide. In Europe, the things that happened at SVB would not have occurred and could not have occurred. So, there was a completely different interest rate regulatory environment. And investors understood that once they started probing.

Why wasn't there a risk of SVB-type issues in Europe? We've got something called the supervisory outlier test; it's a stringent interest rate shock with the output linked to capital. In the UK we've also got Pillar 2A that is held on interest rate risk exposure. So it's quite a different regulatory environment. So I do think it is fit for purpose in Europe.

Donal Quaid, NatWest: I completely agree. From a UK perspective through Pillar 2, it's a very embedded process. If you want to run rate risk in your banking book, you'll be penalised with higher capital requirements in Pillar 2. So again, I completely agree about the big divide.

Rob Collins, Nationwide: The benefit of being a building society is we effectively can't take a view on rates, so everything we buy from that perspective is a package. So, it's swapped back to floating sterling and that keeps life very simple for us.

Toby Fildes, GC: I can imagine what your answer is going to be to this question so let's skip over the obvious answer but are banks the safe profitable and recovering sector? Or, as some bears have it, opaque behemoths ripe for disruption and acutely vulnerable?

Donal Quaid, NatWest: I don't think the two are mutually exclusive. What we've seen is — given the rate environment — that banks' performance in terms of returns has improved considerably over the last few years. But, again taking UK and Europe, the derisking the banks have done over the past 10 years is incredible. The balance sheet strength is fundamentally different from what it was in the pre-GFC world.

Saying that, there's no doubt in terms of the advanced technology firms, there are definitely risks to certain parts of the business model. We are obviously a heavily regulated industry, so our ability to move as dynamically as other players is difficult. But then again, the regulatory threshold for players in parts of the banking market is also high, so the barriers to entry are high in certain aspects.

Daniel Fairclough, Barclays: The fundamental core purpose of the banks that I don't think anyone else is stepping into is maturity transformation and credit creation. So that is always going to be at the core. And innovation and competition at the edges can then spur positive changes in banks.

Toby Fildes, GC: Are you concerned about the role or the move by, call it private debt, in terms of credit creation? Would you count them on that periphery, or would you say they're more central to that now?

Daniel Fairclough, Barclays: I'm not sure it creates credit in the way that the fractional banking system does where you hold deposits and you lend out into the economy as loans. So I view that link between deposits and loans as core to what banks do, that's credit creation.

Toby Fildes, GC: OK.

Rob Collins, Nationwide: There's the trust piece there as well. We all sit behind these brand names that are trusted by the general public in a retail banking context. So that's definitely part of the story. Let's not forget there has been a long burning attempt to create smaller banking firms to challenge and one could argue the relative success or otherwise of that, where some of those challengers are struggling to one degree or another.

Josh Benson, Deutsche: I'm looking more from an equity investor standpoint, but if you look at the banking sector and whether it should be appealing or not, from a fundamentals perspective, absolutely. The risk is always the political aspect as well. We've already seen across Europe windfall taxes. And in times of stress, we've seen the regulator step in as well. So that's always going to be at the back of investors' mind as to whether they should step into the sector.

Toby Fildes, GC: Let me repeat the second half of that question, is

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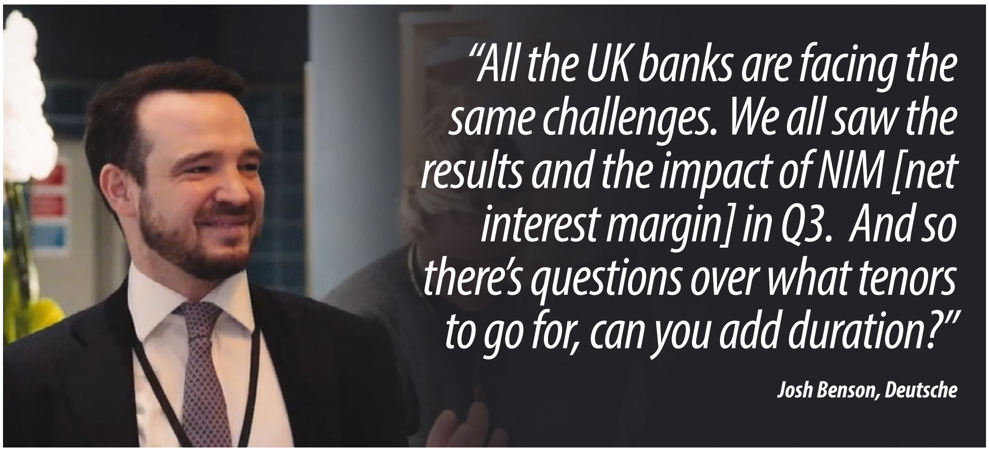
Donal Quaid, NatWest



it ripe for disruption and acutely vulnerable? Does anyone in the audience think that's the case?

Audience member: I do think there's a problem with the resolution regime and that's probably for the whole banking system. And I have a question: if Credit Suisse had gone into resolution rather than being bought by UBS, what would the market impact have been? If the answer is total crisis, then you have to ask: does the resolution regime actually work?

Daniel Fairclough, Barclays: I like to think it would have been manageable and the regulator probably thought it was manageable. I'm sure they had a plan B from the takeover, but we didn't get to find out this time.

But the other thing about all of the different resolution situations that we've had is that in different situations, bits of the toolbox has been tested. Bail-in capital has been used for example, albeit in an M&A context. So I don't think we've seen the full package used in quite the textbook way but we've certainly seen different bits of it being tested.

Donal Quaid, NatWest: I think that question hasn't been answered. You probably need something like a G-SIB or a large organisation to be resolved to prove that the framework works. But I agree, definitely there are a lot of parts that are working but is a full bail-in of the total capital stack doable? We'll wait and see.

Toby Fildes, GC: I know it's a totally different era but do you think the regulators are still worried about what happened immediately after Lehman and therefore they will prefer at all costs to find some likely UBS to come in and rescue? To avoid that total crisis?

Daniel Fairclough, Barclays: Clearly it would have been more chaotic. There's no doubt about it. The regulators are probably going to prefer that as a plan B, rather than plan A. The question is, would it actually work or not?

Rob Collins, Nationwide: The regulator may say that situation encourages them to try and engage with someone who can help out, like a UBS. That in itself is a good by-product of the resolution regime, trying to make sure it very rarely happens is not a bad outcome.

Toby Fildes, GC: Okay. So how are we feeling about 2024? Josh, starting with you, can we expect issuance volumes, bank capital to be up on this year?

Josh Benson, Deutsche: Bank capital specifically, I would say similar to this year. Funnily enough, when we speak about regulation, your mind always turns to capital issuance rates but over the course of the past 12 to 18 months, a massive focus of regulation has of course been liquidity. There's been a period where banks haven't needed to go through substantial funding cycles because of the central bank liquidity that has been injected [to the system].

Clearly that cycle is coming to an end and the question is, does the market have the capacity to digest the additional supply that's expected in what I call those traditional funding instruments — covered bonds, RMBS. The short answer is yes, but it's going to be ever more important for sequencing, timing etc.

That said, January is expected to be busy. We also have a lot of macro news next year; something along the lines of 50% of the world are going to elections next year. We've obviously got the big one in the US towards the end of the year and volatility will come with that, particularly if Donald Trump starts to rise in the polls.

So issuance is likely to be front-loaded but it will be skewed towards the more funding-style instruments rather than capital. There's more than enough capacity in the market to digest capital instruments.

Toby Fildes, GC: Yes. So the markets are feeling good but there's a lot to do next year. There's potential — with lots of hurdles.

Josh Benson, Deutsche: Yes. All the UK banks are facing the same challenges. We all saw the results and the impact of NIM [net interest margin] in Q3. And so there's questions over what tenors to go for, can you add duration? Probably not in this instance. So a lot of banks are going to be looking at the same instruments at the same moment. The UK banks are likely to be looking at more volume but in a shorter space of time [when taking into account the macro events].

Rob Collins, Nationwide: The question is probably answered for us by the fact that our financial year follows the tax year and we stated with our full year results in May that we had a £6bn-£8bn equivalent ambition in the wholesale space in whatever form. We concluded the upper end of that range before our Q3 was over.

So, there's a signal there that we think next year might be a bit choppy for a number of reasons. The macros that Josh has mentioned, is it a year of two halves? January to June could be fine; then elections coming on to the radar and you might get more talk about an earlier election.

And if you bring that close to home, could National Savings and Investments be a gambling chip in the election stakes and therefore you see competition for retail deposits? Some of the challengers that we've mentioned have got TFSME repayments next year and therefore will likely compete for deposits in the retail space as well. And obviously deposit behaviour more generally; where we are in the housing market led us to think let's get that (funding ask) off the table to see us through to the end of our financial year and see how all of those things are developing.

Donal Quaid, NatWest: From a UK perspective, I expect increased unsecured issuance in the UK banking system, that's clear, based on the points you said. I agree on capital; it's really refinancing and any further evolution of the balance sheet from here. Obviously regulatory headwinds will drive a higher requirement over the next couple of years. But the scale of additional issuance, it's not going to be material.

The key element we've heard here is banks are cheap, so hopefully everyone thinks that way.

Daniel Fairclough, Barclays: Not too much to add. Credit growth is a bit of an uncertainty factor and that could determine whether it's flat or uppish. That's pretty uncertain for the UK and more globally.

Toby Fildes, GC: Yes. I think we've narrowly avoided a general election last night. But who knows? Any questions, ladies and gentlemen?

Audience member: This is less relevant to the UK but clearly does have systemic implications. If you look at the American banks, many of them don't have to count losses on hold to maturity securities in bank capital. And you have a massive difference between those failing common equity tier 1 ratios and their effective tier 1 ratios and they will take losses on hold to maturity treasury securities against their capital. That's clearly got systemic implications, were the interest rate cycle not to turn as it does seem to be. Any comments?

Daniel Fairclough, Barclays: In the US there's a bit of a co-mingling going on of liquidity risk and interest rate risk because you end up using securities in the buffer that are meant to be there for liquidity purposes to hedge your interest rate risk. That's a factor that means the US market is a little bit less transparent. And obviously when you've got a lot of people who hold to maturity, that really puts a light on it.

So, if you believe the institutions are a going concern, it's less of an issue. With SVB it obviously becomes a big issue and a capital issue.

Donal Quaid, NatWest: I would say we're no different in terms of the regulatory requirements for HTC (Held-to-Collect), it's just not extensively used in terms of running open rate risk in the UK. So we would all probably have some element of securities in [held to collect] but the rate risk is generally swapped. So it's floating rate risk.

But I agree, if you look at a comparison from the UK bank perspective, we all run structural hedge programmes, we all have the cash flow hedges that are a negative drag on TNAV, but that doesn't affect regulatory capital. But again, it's hedging accrual of deposit income over a period of time. So there is a different approach in terms of how we run and manage risk versus the US.

Audience member: Bank equity is yielding very low compared to AT1s and tier 2s. How do you run relative pricing of returns of equity versus non-equity capital?

Daniel Fairclough, Barclays: I think the equity is undervalued.

"The regulator may say that situation encourages them to try and engage with someone who can help out, like a UBS. That in itself is a good by-product of the resolution regime, trying to make sure it very rarely happens is not a bad outcome."

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Donal Quaid, NatWest: I'm not too sure if it is driven completely by profitability. You look at where UK banks are trading on a price to book or 4 times 24, 25 earnings. There's an overall challenging UK macro investibility story that's playing out. But I would agree with Dan, if you look at equity it looks undervalued.

Josh Benson, Deutsche: Next year a big theme is going to be proof of capital return, not just in the UK but across Europe. If those can be met and you start to see a confidence that the regulator or the politicians won't step in, then you may see an improvement in the share prices.

Audience member: Will there be any bank M&A in the UK?

Toby Fildes: Significant bank M&A you mean?

Donal Quaid, NatWest: I don't see anything in the next 18 months. We've probably been all talking about the challenger bank sector for years. The threshold for M&A is very, very high when you look at the counterfactual where bank stock is trading on price to book versus buying back your own stock. There's a fundamental valuation discrepancy at present.

Rob Collins, Nationwide: It does feel like something that could happen in the challenger sector. I don't think anyone beyond Sky News has validated the Co-op and Coventry Building Society story. But there are perhaps some obvious partners in that (challenger) space that might have complementary balance sheets that may want to come together. But who knows? GC


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