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Vickers report's capital requirement 'tip of the iceberg'

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Wednesday, October 26, 2011

Call for overhaul of retail banking, as operational changes to banking 'could individually cost £1 billion'

Recommendations to ring-fence retail banking from investment banking will have costly repercussions for UK banks that run way beyond the additional capital requirements that have attracted most attention, warns an adviser.

Chris Tattersall, head of business consulting at Grant Thornton, also states that investors should not underestimate the additional associated cost of overhauling banks' operations.

"Dividing the operations of retail and investment banks will be a lengthy, complex and expensive process," says Tattersall.

Banks are already straining to comply with the list of changes asked of them under new regulations, including Basel III, the Dodd-Frank Act and the Foreign Account Tax Compliance Act. "The cost of separating out their operations increases that complexity, and could cost as much as £1 billion each over three years," says Tattersall. And he adds that, even after the initial investment, continuing annual operating costs will also rise markedly.

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Ring-fencing – as outlined by Sir John Vickers' Independent Commission on Banking, which was released on September 12 – is intended to isolate high-street banking operations from riskier investment banking activity. The report recommends that large UK retail banks should have equity capital of at least 10% of risk-weighted assets. This exceeds the Basel III minimum of 7% equity capital requirements.

As EU leaders continue to discuss proposals for a recapitalization scheme for banks, capital continues to dominate news on banking reform across the continent. But as Tattersall says, the current preoccupation with higher capital requirements "is only the tip of the iceberg". He argues: "Banking cannot be neatly split into either retail or investment divisions. For instance, where would wealth management and commercial banking fit?

"Extremely high-net-worth individuals could be considered to act more like companies in behaviour. So, if sophisticated banking instruments are to be kept outside the ring-fence, but wealth management functions are within it, this creates a difficult situation for the client, who may not be able to participate in higher risk banking investments that he would traditionally like to have taken part in."

Deciding what is included and excluded from the ring-fence is only one part of the problem. The choice between the division or integration of underlying operational systems brings additional complexity.

"Within a bank, all divisions need to use the payments function and there is typically only one set of payment systems," says Tattersall. "[As a result], banks will need to decide where the payments function will sit – inside or outside the ring-fence – and how the divisions on the other side can make use of it."

The takeover of ABN Amro by a consortium of Santander, Fortis and RBS in 2007 highlighted some of the problems. "While Santander had a relatively easy time, Fortis, which bought the domestic retail sections of ABN Amro, and RBS, which took over the investment side of things, found the division incredibly difficult," explains Tattersall.

Three years on, the division between the branches has still not been completed. "Even RBS, the masters of integration, has struggled to separate and then integrate the pieces of ABN Amro," says Tattersall.

There are three ways for banks to deal with operational separation. Firstly, banks could create two separate operational systems – one inside the ring fence and one outside. This would be very expensive. It would require a complete split of all front, middle and back office functions between the retail and investment arms of the bank, and a duplication of all processes, roles and technology infrastructure.

"Based on our past experience of delivering operating model transformation projects, banks can expect to spend up to £1 billion over a three-year period should they choose this route," says Tattersall. "They should then expect to see annual operating costs rise by around 50%."

The second option for banks is the creation of a single operational system for both retail and investment banking activity, though the question then arises whether or not it would be included within the ring-fence. Presumably, regulators would regard it as a key piece to be preserved amid any systemic or bank specific crisis.

A third option builds on this idea of a combined operational system and sees banks outsourcing the function. "Creating a combined transaction processing utility will cost around 50% less in set-up costs than the complete separation model – a potential saving of £500 million," says Tattersall. "In addition, operational costs under this model would only increase by around 20% per annum."

Jointly funded operational utilities with many bank users have been conceived in the past. Arcordia was an attempt in the early part of the last decade to create a utility for participants in the OTC derivatives markets. It was shut down in 2001, having only managed to bring in one external client.

“What might happen as a result of the Vickers report is that banks with strong processing capabilities may reconsider the business case for a utility option, while banks with less strong processing capability might find outsourcing to a utility rather more attractive,” says Tattersall.

Whatever path banks take, “they will not be able to go back to business as usual”, says Julian Ferguson, director of marketing at Bourton Group, a management consultancy specializing in operational performance improvement.

Ring-fencing will not only create expensive operational changes for banks, it will also affect overall profitability for retail branches.

Universal banks argue that investment banking is very profitable and retail banking is not. “What banks imply is that investment banking indirectly subsidises retail banking,” says Ferguson. “Once you ring-fence retail banks they have to stand on their own.”

As a result, retail banks will need to increase charges if they are not to give up retail banking altogether and concentrate on investment banking instead. Regulators, of course, want more competition not less.

A second option would be for banks to change the type of retail banking service they offer to attract more customers. Ferguson says: “All we are offered by high-street banks at the moment are expensive vanilla services. If banks continue to go along the way they are, then they will inevitably lose market share to the Tescos of this world.”

He suggests that banks will need to get back to “a differentiated, more added value and personal service”. This might even bring a return to “the bank manager of old, who charged interest on the basis of an understanding of the risk involved and personal relationship with the client”.

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