Bank Regulation Investment Theme.

One of the most interesting and rewarding investment opportunities currently available trades on the reform of the banking sector. We live in a world where, unfortunately, pragmatism has for too long trumped ideology. This lack of a guiding philosophy had led banks to myopia and to overreach themselves resulting in over-levered balance sheets and inappropriate operating practices, culminating in the financial crisis of 6 years ago. Regulators are still trying to reform the banking system and this has produced a host of investment opportunities.

What is the raison d'être of a bank; why does it exist and what is its place in the economy? A bank exists to borrow money from those who have more than they can currently spend or invest and to lend it to those who have less than they can currently spend or invest. A bank is therefore no more than an intermediary. From this function, pragmatism and the profit motive led banks to turning their credit expertise to bond arranging and underwriting and ultimately to trading and hedging. From bonds, this same capability was extended to equities, commodities, foreign exchange and pretty much anything for which a market could be created. The liquidity provided by banks trading serves a useful purpose in price discovery and risk transfer. However, as is often the case, when competency trails behind the state of the art, or complacency or hubris develops, banks can and have overreached themselves leading to credit crises. Glass-Steagall in 1933 and more recently Dodd Frank are legislation enacted to manage this tendency for efficiency to dominate stability and governance, especially when clever minds are at work.

One of the primary sources of instability is not just the commingling of principal and agency activities in a bank but rather the liquidity mismatch between its assets and liabilities. This mismatch arises because banks borrow short term from depositors and each other, and lend longer term to businesses and homeowners. Normalized interest rate term structures mean that banks earn a higher interest rate lending long and pay a lower cost of funds borrowing short. This is efficient but inherently unstable. So far, no rules, limits or regulatory device have been able to mitigate the force of fear during a bank run. One way by which the financial industry has sought to address this liquidity mismatch, is the so-called Shadow Banking system. This is a parallel funding system where it is hoped that the liquidity or maturity between assets and liabilities can be matched. More cynically, they are a means of circumventing regulatory capital requirements. Generally, Shadow Banks are thought of as any non-bank institution conducting a banking business. Structured Investment Vehicles, Collateralized Debt Obligations, Collateralized Loan Obligations, Private Debt or Private Equity funds, indeed even mutual funds, can be considered part of the Shadow Banking system.

In the run up to 2008, banks who witnessed demand outstrip capital saw Shadow Banking as an outlet, but as with trading and hedging before, competency and circumspection trailed the state of the art and avarice, and before long the Shadow Bank’s collapsed, and collapsed onto the banks themselves. Regulators were quick, though late, to step in to regulate the financial system and in such a way as to limit banks to focus on their core reason for being, that is to borrow and to lend safely. This regulation, unlike the singular Banking Act of 1933 is a raft of international sanctions. As such they will be more difficult to dismantle than Glass-Steagall which was repealed by Graham-Leach-Bliley in 1999. Basel 3, Solvency 2, Dodd Frank and the Volcker Rule are some of the fragmented rules that banks will have to navigate in future.

Herein lies the investment opportunity. New leverage and capital rules will discourage banks from certain types of lending, from many types of trading, and encourage banks to restructure their balance sheets through asset sales, new methods of funding and accounting acrobatics.

Where banks are retreating from lending, returns can be earned for replacing them. Examples of this are private debt funds that lend directly to small and medium sized enterprises, to fund infrastructure or to real estate development and do so flexibly to the benefit of both borrower and lender. Many of these funds work with banks, to reduce the leverage of the bank's funding, enabling them to lend efficiently while complying with the new regulations. Investors in such funds can reap a liquidity premium in addition to the credit spread. Returns to secured lending can be as high as the mid teens.

Where banks are no longer trading, the public traded capital structures of companies have become improperly priced leading to arbitrage opportunities. Capital structures used to be policed by bank trading desks as they trade across equities, preferred shares, bonds and loans. Mutual funds tend to segregate trading of such securities so that the pricing of one segment relative to another is not arbitraged away. Only a small group of hedge funds did this. They are now growing as banks shutter their trading desks and traders have to find a new home. Capital structure and credit arbitrage hedge funds generate very attractive risk adjusted returns.

Banks own capital structures are inefficient. The financial crisis led to bank bailouts and rescues that necessitated emergency capital structures. As the crisis has waned and new regulation is implemented these capital structures are no longer efficient. Some capital securities will be reclassified as debt. Some apparently dangerous securities such as CoCos (contingent convertibles) are being deleveraged making them safer than the market thinks. Some of the most lucrative trades will be in the trading of bank securities across their capital structures. Some mutual funds and hedge funds are active in these securities.

Asset sales are another means of deleveraging bank balance sheets to comply with new capital rules. These assets need a new home and, at the right price, even apparently poor assets can make good investments. Distressed asset funds are on the prowl for such assets.

Lending to banks in creative ways can also be lucrative. Some private debt funds do this. By providing capital relief on assets that remain on the borrowing bank’s balance sheet, these lenders release capital allowing the bank to continue to lend. For this service they exact a high yield on their capital. Some very specialized funds invest in this area. There is even one such fund based in Singapore.

The strategies arising from bank regulation are diverse and offer rewards to risks other than market risks and therefore are a useful diversifier in any investment portfolio. The issue with these strategies is that they are often either illiquid and thus require term capital or they are complex and require special analysis. The shame is that these opportunities will likely not be made available to retail investor but will remain the preserve of institutional investors.