Bauerle's Bank Notes

Morph Speed

June 2, 2016

"Existential crisis" and "bank" are not words usually used in the same sentence. But "The Existential Crisis Facing Banks in 2016" was the Wall Street Journal's headline Tuesday as it began a week-long series of articles about changes roiling the industry.[i] WSJ columnist Dennis Berman asserted the industry is torn among multiple identities.

> In 2016 a big bank also doubles as an enterprise software company and a mobile-apps developer. It is a customer-service organization to big companies and individuals alike. It is a tool of government-mandated social policy. A shareholder-return engine. An international intermediary. A seller and trader of securities. A policeman of criminals. A policeman of itself. And, of late, a public vessel, dirtied by political feeling about everything from inequality to race to Congress to the U.S. Constitution itself.[ii]

The need for banks to serve competing agendas is hardly new. At the dawn of the Industrial Revolution, banks served as guardians of the nation's savings, conduits for European investors who funded railroad construction, agents of the federal government as it waged the War Between the States and a powerful force for economic development of the nation west of the Alleghenies.

What is different today is the proliferation of non-bank competitors, all of whom are carving on the turkey of banks' earnings without paying for the privilege. Banking trade groups focus their fire on credit unions or the Wall Street vs. Main Street dichotomy. Underappreciated is the threat that Silicon Valley represents. One suspects the trade groups' membership is divided in its perspectives, making it difficult to frame a consensus strategy. Yet certain elements of the competitive threat are indisputably a clear and present danger to banking today.

1. Porous Boundaries. The 80 year old bank regulatory framework is leaky as a sieve, because it does not extend to the new entrants. For example, Chinese investment group Shanda last week increased to 11.7% its stake in LendingClub, the troubled Internet loan marketplace, with options to acquire an additional 4.1% of the company's

equity.[iii] Shanda now holds the largest position in LendingClub. Were LendingClub a bank, that action would presumptively make Shanda a bank holding company subject to regulation by the Federal Reserve System. The acquisition of 10% or more of LendingClub's equity would also require Federal Reserve Board approval, an unlikely result given Shanda's country of origin. Similarly, a community bank network called BancAlliance has acknowledged its members are significant purchasers of LendingClub loans. So any deficiencies in LendingClub loan underwriting practices have already found their way into the banking system, making it impossible to say that LendingClub's fate is of no consequence to insured depository institutions.

2. Eroded Margins. Before its 2014 IPO, Alibaba, the Chinese Internet marketplace company, spun off Ant Financial, an Internet financial services platform that offers both payment services like PayPal and consumer loans.[iv] Ant is expected to conduct an IPO of its own shares eventually. Its latest funding round values the company at $60 billion. Its large shareholders include the $740 billion sovereign-wealth fund China Investment Corp. and the country's national social security fund. That level of state-sponsorship dwarfs the economic advantage American banks derive from low-cost insured bank deposits as a balance sheet funding mechanism.

Further, Ant's ability, like PayPal's, to hold funds off-shore in tax-havens gives it an advantage over U.S. banks whose income or shares are subject to taxation. Public controversy has focused on pharmaceutical companies' corporate inversions and technology companies' stashing of cash in foreign jurisdictions. The banking industry's competitive vulnerability to off-shore activity by non-bank competitors is an issue of at least equal magnitude.

3. M&A. The nature of the banking business and the regulatory environment in which it must be conducted put banks at a disadvantage when it comes to acquiring companies with breakthrough technology. They simply cannot pay the prices technology companies command if they use traditional bank M&A strategies.

No single solution to this competitive dilemma exists. Needed first is recognition of the problem and awareness that, because of its size and scope, both industry and government resources need to be marshaled to address it. Elements of a coordinated response include the following:

A. Widening Regulators' Reach. The OCC and the CFPB have signaled their intention to extend their authority to encompass fintech companies. These moves are essential and need to be pursued with vigor and imagination equivalent to that of the Silicon Valley *wunderkinder* who say they are on a mission "to transform the banking industry."

B. Pay to Play. Congress cannot continue to ignore the off-shoring of earnings and profits derived from U.S. business activities by technology and non-bank financial companies. Compared to big technology and pharmaceutical companies, banks are virtuous citizens who work hard, play by the rules and pay their tax obligations on time and in full. Political hay should be made of this phenomenon.

A central legal precept of state and federal tax law is that to do business in any state requires submission to that state's legal jurisdiction including payment of tax on business done in that state. There is no reason Congress cannot apply the same principle to big companies doing business in the U.S. but sheltering profits offshore. Taking that action relative to nonbank financial companies would benefit nearly every U.S.-based bank.

C. Different M&A Strategies. Banking M&A for the last 30 years has be a game of consolidation. That gambit has largely run its course. Needed now are novel strategies and regulatory acceptance of them. For example, years ago we pioneered the use of tracking stocks to permit owners of a minority position in an insurance company to receive a pro rata share of earnings and profits without becoming enmeshed in the operation of the business. We used a similar but different strategy to marry a capital-rich partner with an operational innovator in another novel insurance industry deal. In each case, we won over regulators despite their initial reluctance about our innovations. These approaches and other sensible tactics can be applied in the banking business. The result can be the needed synthesis of bank capital with fintech business model innovation and efficiency.

Another opportunity for thinking differently applies to consolidation of banks. As banks sharpen their focus on profitability measurement and management, they should more seriously consider divesting business units that are acquired as part of a whole bank purchase but that don't fit well strategically. Others may pay handsomely for the divested units because they can make more of them than the acquiring bank. This behavior has been standard operating procedure in the non-bank environment for decades. There is no reason banks should not embrace it.

D. Morph Speed. In the auto industry, Korean manufacturer Hyundai refers to "Hyundai Time," the expectation that tasks will be accomplished at three and four times the pace of other manufacturers' staffs. Banks, and their regulators especially, need to embrace this greater sense of urgency. The Silicon Valley competition does.

There is no reason banks cannot succeed in the race with fintech, especially fintech companies based overseas. "Existential crisis" is an overwrought phrase for the challenge at hand. Success, however, requires openness to innovation, collaboration with interested parties including regulators, and a sense of urgency about the challenge and opportunity.

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[i] http://graphics.wsj.com/what-is-a-bank/

[ii] Id.

[iii] http://www.ft.com/cms/s/0/d3fd904c-20fd-11e6-aa98-db1e01fabc0c.html#axzz4ALx2725j.

[iv] http://blogs.wsj.com/briefly/2016/04/26/5-things-to-know-about-chinas-ant-financial/

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