The dynamics of responsibility in corporate and wholesale finance

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The Dynamics of Responsibility and Risk in Corporate and Wholesale Finance

by

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ABSTRACT

The paper examines the traditional function of commercial banks as financial intermediaries between deficit and surplus sectors. Fundamental to this function has been the assumption that banks can intermediate at lower costs than those prevailing with direct financing arrangements, but developments in corporate wholesale financing over the past twenty years or so have significantly undermined this "cost imperative" for large national and international companies. This has resulted in significant disintermediation of commercial banks by large companies and raised the question as to whether this development signals merely another evolutionary phase in modern banking or something far more fundamental.

Commercial banks have responded to these changes by becoming more investment bank oriented. Traditional on-balance sheet services for large companies have, therefore, been largely replaced by the off-balance sheet activities of providing investment advice, making placements, the provision of standby facilities, etc. These fundamental changes in business activity have had a marked effect on the commercial banks' principal sources of income and the risks inherent in their business. Just as important, however, is the fact that changes in corporate wholesale banking have far-reaching implications which go far beyond the corporate wholesale market and have fundamentally changed the commercial banks' "business philosophy" and methods of conducting business.
INTRODUCTION

The traditional function of commercial banks has been to act as financial intermediaries between deficit and surplus sectors (Heffernan, 1996) but fundamental to this process has been the assumption that banks can intermediate at lower costs than those prevailing in direct financing arrangements (Gurley and Shaw, 1960). Developments in corporate wholesale financing over the past twenty years or so have, however, significantly undermined this “cost imperative” for large national and international companies. This has resulted in significant disintermediation of commercial banks by large companies and raised the question as to whether this development signals merely another evolutionary phase in modern banking or something far more fundamental (Gardener and Revell, 1988).

Commercial banks have responded to these changes by becoming more investment bank oriented (Rabczynski, 1996). Traditional on-balance sheet services for large companies have, therefore, been largely replaced by the off-balance sheet activities of providing investment advice, making placements and the provision of standby facilities, etc. These fundamental changes in business activity have had a marked effect on the commercial banks’ principal sources of income, but perhaps, just as important, on the risks inherent in the business. Equally, these changes have had an effect on the bank’s business philosophy and how they conduct their business which have quite marked social and economic implications which impinge far beyond wholesale banking.

AN HISTORICAL PERSPECTIVE: THE GROWTH IN WHOLESALE FINANCIAL INTERMEDIATION

Before these sort of issues and their implications for modern day banking can be discussed in detail, it is important to take an historical perspective in order to understand why there has been this shift away from wholesale financial intermediation. The biggest impetus to commercial banks’ corporate wholesale activities and, therefore, perhaps the logical starting point, was the quintupling of oil prices in 1974. This resulted in massive deficits in the current accounts of OECD and non-OPEC lesser developed countries (LDCs). An insight into the sheer magnitude of these imbalances and the enormity of the financing problem is revealed by the fact that the combined current account deficits of these two country groupings increased from $2 billion in 1973 to $52 billion the following year. Subsequent hikes in the price of oil
in 1978 ensured that these imbalances continued, eventually peaking in 1981 at $105 billion! The brunt of the adjustment process, however, fell on non-OPEC LDCs whose current account deficits alone totalled $85 billion during 1981. The traditional providers of international finance, namely the International Monetary Fund (IMF) and the World Bank, simply lacked the resources to finance imbalances on this scale and as a consequence the vacuum was filled by the World's private commercial banks (United Nations, 1991).

History bears testimony to the fact that between 1974-82 private commercial banks were only too willing to participate in wholesale business. The growth in syndicated bank lending, for example, was quite spectacular, increasing from 226 announced deals with a total value of $7.4 billion in 1972 to 1,070 deals with a total value of $131.5 billion at its peak in 1981. Similarly, throughout the period 1974-78 the Eurocurrency market was growing at an annual rate of approximately 25 per cent per annum, suggesting that participating banks could double the size of their balance sheets over this four year period. As profits did not keep pace with this growth, capital inadequacy emerged as a serious problem for the banks and eventually undermined shareholder confidence. The reasons underpinning the private commercial banks' willingness to enter these new markets are varied, but perhaps it would be unfair and probably untrue to suggest that they were simply awash with deposits and were desperate to onlend these funds. Banks, like conventional businesses, think strategically in terms of asset growth rather than liability growth. In other words, they decided by how much they wanted to see assets grow, which markets they wanted to be in, what products they wanted to be associated with, etc, and then sought to finance their expansion plans via deposit acquisition. For about three to four years after the initial oil price hike, private commercial banks gave every indication of wanting OPBC deposits by actively competing against each other and increasing bid prices. This suggests that they had clear ideas regarding how and where these resources were going to be deployed. The new markets presented by the financing requirements of LDCs emerged at exactly the time when the banks' traditional domestic markets, triggered by the oil crisis, were going through deep recession. As such, they presented the banks with an opportunity to enter new markets and diversify their business. The herd instinct, so strong in banks at the best of times, prevailed and almost all banks, irrespective of size and experience, were eager to take advantage of the new opportunities which the new markets presented. This
“follow-me-leader” attitude was also facilitated by syndicated lending which allowed relatively small and inexperienced banks to join international syndications as participants.

In order to get a foot-hold in these new LDC markets, there is also strong evidence to suggest that commercial banks adopted a loss leader strategy or were, at least, prepared to lend on extremely attractive terms. Maturities on syndicated lending, for example, increased from an average of 6.57 years in 1972 to 8.71 years by 1979 and spreads (using spreads as a proxy for price) decreased from 1.56 per cent in 1975 to 0.71 per cent in 1981. When account is taken of the bid rates prevailing at the time, it becomes very clear that the private banks were operating on extremely fine margins and offering terms which, in many respects, were more attractive than the official sector (Edwards, 1984).

This encouraged excessive consumption of private bank finance which, combined with the vagaries of balance of payments financing and the ensuing capital flight (spurred on by cheap borrowing and high earning, relatively risk free bank deposits) began to make the private commercial banks feel increasingly uncomfortable. Consequently, from about 1978 there was a perceptible shift away from sovereign lending and balance of payments financing towards project financing with its emphasis on collateral and repayment from the future dedicated cash flows of projects. This change in the mode of financing facilitated a continuation of wholesale financing to LDCs until 1983 when rather than incur the stigma (and wrath of the banks) of outright default, several major debtor countries rescheduled their debt. During this year $63 billion, approximately 9 per cent of outstanding private debt, was rescheduled and this signalled a virtual end to the wholesale financial intermediation of the previous nine years and the beginning of a new era in wholesale banking.

Several initiatives, notably from Secretaries Brady and Baker of the US Government, attempted to persuade private banks to initiate new advances to the most heavily indebted developing countries, but the success of these plans was modest (Kaletsky, 1985). As a result, from 1984 through to 1990 capital flight combined with interest repayments on outstanding debt meant that there was an implied net transfer of resources from developing countries to the lending banks located in the industrialised countries. Concerns about the ability of the principal debtor countries to control their respective economies and repay outstanding
principal persisted throughout the remainder of the 1980s and a high proportion of internationally renowned banks had their triple-A credit rating reduced by Standard and Poor's and Moody's. Not only did this adversely affect the propensity of investors to place international deposits with the banks, but it also reduced shareholder confidence. Consequently, in 1986 the international banking fraternity, led by the example set in America, began attempting to strengthen their balance sheets by making substantial provisions for bad and doubtful Third World debts.

In 1987 the UK's four main banks' (Barclays, Lloyds, Midland and NatWest) total exposure to LDC debt amounted to £14.7 billion and in the instances of Lloyds and Midland their exposures were greater than their total capital. Consequently, when provisions ranging from 25-28 per cent of outstanding debt were made during that year, Lloyds and Midland saw their hitherto substantial profits reduced to losses of £248 million and £505 million respectively. This rather painful action was thought necessary to strengthen the banks' balance sheets, but there was undoubtedly a certain amount of politicking between the UK banks aimed primarily at Midland Bank, whose balance sheet position had already been weakened, notably by the acquisition of Crocker Bank in the United States. In any event, the better performance of Latin American countries, especially towards the end of the 1980s, saw provisions being eventually clawed back into profits and, to some extent, this offset bank losses which were incurred in the economic recession of the early 1990s. The ability to securitise Latin American debt and repackage or transform essentially illiquid financial assets into liquid securities also helped to resolve the problem of bank exposure as did their ability to sell Third World debt (Bray, 1984; The Banker, 1991).

With retrospect the obvious question to ask is: was the financing option the best solution to non-OPEC LDC deficits? From the perspective of industrialised countries, so-called "recycling" could not prevent economic recession, but at least it avoided a World depression by facilitating relatively high volumes of international trade at fairly buoyant prices. Within industrialised countries, financing of external deficits by the banking sector also meant that the problem became relatively short term for the other sectors in the economy. The exception, of course, was the banking sector itself which was to inherit Third World debt problems for the next fifteen years or so. From both a political and economic viewpoint, however, "sacrificing"
the banks in this way was probably a reasonably price to pay when viewed against the lack of alternative solutions and the distinct possibility of World depression. It is perhaps also worthwhile reflecting on the fact that governments under pressure find it politically expedient to periodically criticise or penalise the banking system and in this respect the 1970s was no exception.

From the perspective of non-OPEC LDCs, they undoubtedly bore the brunt of the industrialised countries re-adjustment process despite being worse placed to afford it. From an economic perspective, however, financing the balance of payments deficits did alleviate much of the short term hardship which otherwise would have resulted in these countries. Moreover, if the bank finance which was released into the private entrepreneurial sectors in Latin America had been used to develop their respective economies, as was the case in Korea and Taiwan, for example, they too would have possibly emerged from the crisis much stronger. In the event, much of the finance released into the LDCs' private sectors resulted in capital flight attracted by the high rates and low risks prevailing on bank deposits in the industrialised countries. As a result, Latin American governments became virtually bankrupt, whereas a minority of private entrepreneurs became extremely wealthy. This served to further polarise the economic and social dualism which has always existed in these countries. Finally, from a political perspective, financing the deficits was extremely efficient because governments typically elected for three to five years could borrow in excess of ten years and, therefore, need not concern themselves about eventual repayment and the economic and social hardships which this might entail.

SECURITISATION AND DISINTERMEDIATION: THE IMPLICATIONS FOR COMMERCIAL BANKING

Since 1983 the OPEC surpluses, the counterpart of non-OPEC LDC deficits, have been replaced by deficits and the position which OPEC occupied through the 1970s, as the World's surplus sector, has been taken over by Japan. This structural change in the World's balance of payments together with changing perceptions about the riskiness of banks brought about a significant change in investor demand preferences. In contrast to OPEC investors' risk aversion and preference for liquidity, characteristics which are generally associated with bank deposits, the profile of the emergent investors was more sophisticated with a preference for
direct investment in capital market instruments. It is important, however, to recognise that many of the innovations which have liquefied or securitised the Euromarkets were also supply led in the sense that the banks themselves initiated some of the changes. Banks have responded and, in some instances, anticipated gaps in the supply and demand disequilibrium in financial markets. This gap, which is referred to in the literature as “the financial preference gap”, exists when market participants either require a new form of intermediation or would purchase new financial investments if they existed. The process of liquefaction, therefore, involves the identification of gaps or latent demand in the market and a response to the expressed requirements and desires of market participants. In this respect, it is important to remember that both the dynamics of supply and demand in the Eurocurrency markets have been responsible for innovations in financial and capital market investments (Feeney, 1987).

Securitisation has generated a wide range of new instruments (Henderson and Scott, 1988), but for the purposes of this paper attention will be focussed on those shown in Table 1, namely bonds and Euronote facilities. Even with such a limited focus, it is important to recognise that the actual process of securitisation can be discussed at two broad levels (Gardener and Revell, 1988). The first, or primary level, involves commercial banks (and financial institutions) securitising existing illiquid portfolios by repackaging the assets in an acceptable form and selling them on as securities in the open market. In the United States, in particular, large markets have developed in loan-asset backed securities for car loans, mortgages and a wide range of other bank assets. The common purpose in all of these markets, however, remains the same, namely to resolve the problem of excess demand for loans at prevailing interest rates and existing levels of capitalisation relative to given levels of deposits. Although this type of securitisation involves what Gurley and Shaw (1960) refer to as “direct finance” between the capital market and the banks, it also allows the banks to supplement their deposits which have been depleted by changes in investor demand preference. To some extent, therefore, this type of securitisation can also be regarded as a form of “indirect finance” or financial intermediation.

The secondary level of securitisation represents a serious challenge to commercial banking because it is exclusively concerned with direct financing and, therefore, involves the process of bank disintermediation, whereby flows through financial instruments are displaced by flows
through capital markets (Kasi, 1990). Table 1 provides an insight into this trend over the period 1981-1996 showing that at the beginning of this period Eurocurrency syndicated lending was approximately 320 per cent greater than securities market activity, but that from 1983 onwards these positions were reversed (BIS, 1997). Despite the continued dominant position of capital market activity over bank lending for well over a decade, the past few years have witnessed a revival in bank syndicated lending (Howcroft, forthcoming; Garrity, 1997).

To some extent, however, this revival has been secured on the back of reduced margins to high rated names and this serves to illustrate the importance for banks in linking this business to more lucrative or complicated services and also seeking higher returns through loans to smaller companies and personal customers (Gerner, 1997).

Apart from the changing demand preferences of investors, the growing importance of the securities markets also reflects how innovative banks have been in responding to latent demand and the requirements of market participants. Bond financing has accordingly evolved from exclusive reliance on fixed rate finance in the 1960s to floating rate notes and instruments which incorporate convertibility and a variety of warranties. The best examples of innovation and growth over a relatively short period have, however, come from Euronotes which were first introduced onto the European markets in 1978 (BIS, 1986). The notes themselves are basically short term bearer promissory notes issued for a set maturity, usually on a discount to yield basis, and denominated in a variety of currencies but usually in US Dollars, ECU's and Hong Kong Dollars. Face values and maturities are similarly varied, for example, the face value of individual notes ranges from US $10,000 to US $500,000 and maturities range from 7 days to up to one year, although issues of up to five years are not unusual and some medium terms notes in the States (despite the word "medium") have had maturities in excess of 30 years.

In addition to the flexibility of the notes themselves, the success of Euronote facilities has also been due to the responsiveness of the banks in changing the issuance mechanisms to reflect the various and sometimes conflicting needs of market players. As a consequence, the Revolving Underwritten Facility (RUF) was replaced by the Note Issuance Facility (NIF) in the early 1980s.
Table 1
International Financial Activity ($bn)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>Securities Markets Instruments:</td>
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<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Fixed Rate Bonds (straights)</td>
<td>32.1</td>
<td>56.4</td>
<td>50.0</td>
<td>65.5</td>
<td>108.6</td>
<td>172.6</td>
<td>163.6</td>
<td>160.0</td>
<td>149.9</td>
<td>166.5</td>
<td>275.3</td>
<td>296.1</td>
<td>351.0</td>
</tr>
<tr>
<td>Floating Rate Bonds (FRNs)</td>
<td>7.8</td>
<td>12.6</td>
<td>15.3</td>
<td>34.1</td>
<td>55.9</td>
<td>47.8</td>
<td>12.0</td>
<td>23.5</td>
<td>23.4</td>
<td>42.1</td>
<td>42.8</td>
<td>92.7</td>
<td>176.4</td>
</tr>
<tr>
<td>Euronote Facilities inc Underwritten Faculties (NIFs, RUFs, etc)</td>
<td>1.0</td>
<td>2.3</td>
<td>3.3</td>
<td>18.8</td>
<td>5.3</td>
<td>57.2</td>
<td>37.3</td>
<td>10.6</td>
<td>10.3</td>
<td>3.0</td>
<td>10.2</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Medium Term Notes (MTNs)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>16.3</td>
<td>12.2</td>
<td>22.1</td>
<td>22.6</td>
<td>157.0</td>
<td>223.9</td>
</tr>
<tr>
<td>Euro-Commercial Paper (ECP)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>13.9</td>
<td>46.1</td>
<td>19.9</td>
<td>5.3</td>
<td>11.8</td>
<td>0.9</td>
<td>36.4</td>
</tr>
<tr>
<td>Total Securities Market</td>
<td>40.9</td>
<td>71.3</td>
<td>68.6</td>
<td>118.4</td>
<td>214.8</td>
<td>291.5</td>
<td>259.0</td>
<td>230.0</td>
<td>201.1</td>
<td>245.5</td>
<td>350.0</td>
<td>582.2</td>
<td>792.4</td>
</tr>
<tr>
<td>Announced Eurocurrency Syndicated Loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>131.5</td>
<td>88.2</td>
<td>38.1</td>
<td>31.3</td>
<td>19.0</td>
<td>29.8</td>
<td>87.9</td>
<td>101.8</td>
<td>149.0</td>
<td>165.2</td>
<td>68.7</td>
<td>248.6</td>
<td>530.0</td>
<td></td>
</tr>
</tbody>
</table>

Source: Bank of England, BIS Annual Reports
As Figure 1 shows, the RUF was a sole placing agent mechanism in which bids were made at an agreed fixed rate and the underwriting group had no opportunity to acquire notes until they were called upon to underwrite. Settlement took about 10 days and this raised concerns amongst issuers that just one bank acting on their behalf, i.e., the sole agent, did not have the necessary international network to quickly get the best deal for the customer or even sell the entire issue. Moreover, as bids were at an agreed fixed price, any windfall gain emanating from higher than expected investor demand went to the sole agent rather than the issuer.

Figure 1
Revolving Underwritten Facility (RUF)

Apart from the issuer’s concerns, the underwriting group was also dissatisfied because they were prohibited from bidding for the notes and, therefore, did not have an opportunity to purchase them until they were called upon to underwrite the issue. This situation usually occurred when there was low investor demand typically caused by overpricing of notes or concerns about the creditworthiness of the issuer.

As a direct consequence of these concerns, the NIF, shown in Figure 2, replaced the sole agent mechanism with a tender panel which could incorporate as many as 100 banks competitively tendering for notes within an agreed floor and ceiling price. Any windfall gains (or at least a fair proportion) were, therefore, passed on to the issuer and because the mechanism involved a relatively large number of bidding banks, the commensurate increase in geographical spread and international networking reduced settlement time to about 5 days. Finally, as the tender panel usually incorporated the underwriting banks (it could also include banks who were not committed to underwrite), they were given the opportunity to bid for notes at the outset of placement.
Both RUFs and NIFs represent investment rather than commercial bank activities and show the banks acting as agents on behalf of clients rather than as financial intermediaries. As such, these activities do not appear on-balance sheet, but rather appear off-balance sheet as contingent liabilities in respect of underwriting commitments. Prior to the 1980s, the contingent liabilities readily associated with commercial banking were limited to guarantees, acceptances and documentary credits, etc and these were taken into account by the central authorities in calculating adequate capital. The emergence and unprecedented growth in Euronote facilities, however, saw central banks effectively lagging behind market practice until 1987 when the introduction of new regulations on capital adequacy brought the underwriting of Euronotes into account when calculating reserve asset ratios (Bank of England, 1987).

This re-regulation of the market was fairly unique in an era of unprecedented deregulation and had a marked effect on Euronote business (see Table 1). It directly gave rise to Euro Commercial Paper (ECP) and, as Figure 3 shows, the emergence of ECPs heralded another distinctive change in wholesale activity.
Under this mechanism the banks do not act as agents on behalf of investors, but rather act as dealers or principals in their own right, either holding the notes until maturity or operating a book and selling them in a secondary market. Equally significant is the fact that this business in on-balance sheet, there being no underwriting facility, with the notes typically appearing as "investments" in the bank’s balance sheet.

The emergence of Euro-Medium-Term Notes (EMTNs) represent the final stage in recent wholesale market innovation by combining some of the features of bonds and Euronotes. Like bonds, they can be underwritten, but they confer much greater flexibility than traditional bond issues. Placement through dealers, for example, represents a discrete way of testing market acceptance for new borrowers compared with traditional Eurobonds. For regular borrowers, EMTN facilities provide a quicker and cheaper way of accessing different pockets of investment demand as they allow the introduction of tailor-made instruments which can often better capture arbitrage opportunities or regulatory loopholes compared with stand-alone international bonds.

![Figure 4](image)

**Hypothetical Example of Costs Associated With Euronotes and Conventional Bank Borrowing**

\[
\text{LIBID} \quad + \quad \text{MARGIN} \quad = \quad \text{LIBOR} \quad + \quad \text{SPREAD}
\]

\[
\text{(Cost of Money)} \quad \downarrow \quad \text{(Overheads)} \quad \downarrow \quad \text{(Selling Price)} \quad \downarrow \quad \text{(Risk Factor)}
\]

\[
4.5\% \quad 0.5\% \quad 5\% \quad 5.5\%
\]

The attraction of Euronote facilities for companies is undoubtedly the additional flexibility they confer on corporate treasurer’s, combined with their relative cheapness compared with more traditional forms of bank finance.

Bank borrowing is, for example, typically priced to risk around LIBOR (5.5% in Figure 4), whereas Euronotes without the margin associated with financial intermediation are usually priced around LIBID plus a maximum (normally) of about 20 basis points (4 7/10 in Figure 4).\(^1\) Similarly, Euronote investors can earn yields in excess of LIBID and, therefore, in excess of prevailing interest rates on bank deposits. For representation purposes, the hypothetical

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\(^1\) For top rated companies A,\(^7/10\), Euronotes have been priced at sub LIBID.
example in Figure 4 exaggerates the differences in costs and returns between Euronotes and traditional financial intermediation, but even slight differences are sufficient to attract investors and borrowers.

To some extent, this reduction in costs and increase in returns is offset by a commensurate increases in risks. In essence, innovations in Euronote facilities have separated all of the various functions and roles which were undertaken by the banks in classical syndicated lending. Accordingly, credit risk, funding risk and pricing risk, etc, which were normally assumed by banks, have been “unbundled” and are now directly carried by either borrowers or investors. For example, with unwritten facilities credit risk is directly assumed by investors and funding and pricing risks by borrowers.

Increased risk should also be considered against the fact that although Euronote facilities constitute direct finance, in the sense that investors invest directly into companies, there is no “relationship” between the two parties. This means that if a particular company went through a crisis, or a difficult trading period, investors would be inclined to liquidate their investments to avoid any significant capital loss. In reality, a bank too would call in the liquidator if a company’s trading position became impossible, but the important question of timing, ie when to liquidate the investment or when to appoint the liquidator, would be quite different. This is because although a bank, like a private investor, is interested in ultimate return and needs to safeguard the investments of its depositors and shareholders, it is in the business of managing risk and within corporate financing, this involves creating a banker-customer relationship and, therefore, by definition taking a longer term perspective than the private investor. To some extent too, there is a social and economic responsibility placed on banks by society to support corporate customers through times of crisis, which most definitely does not apply to the private investor.

Nevertheless, the success of Euronote facilities has been primarily driven by the reduced costs to borrowers and increased returns to investors rather than concerns about increased risks. As Table 2 shows, disintermediation has been taking place for some time in the United Kingdom and France.
Table 2
% of Net Funds Raised by Non-Financial Companies

<table>
<thead>
<tr>
<th></th>
<th>1970 Banks</th>
<th>Other¹</th>
<th>1980 Banks</th>
<th>Other¹</th>
<th>1990 Banks</th>
<th>Other¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>France</td>
<td>90</td>
<td>10</td>
<td>60</td>
<td>40</td>
<td>25</td>
<td>75</td>
</tr>
<tr>
<td>UK</td>
<td>95</td>
<td>5</td>
<td>80</td>
<td>20</td>
<td>20</td>
<td>80</td>
</tr>
<tr>
<td>US</td>
<td>45</td>
<td>55</td>
<td>55</td>
<td>45</td>
<td>(-65)</td>
<td>(70)</td>
</tr>
<tr>
<td>Germany</td>
<td>100</td>
<td>0</td>
<td>95</td>
<td>5</td>
<td>80</td>
<td>20</td>
</tr>
</tbody>
</table>

¹ Bonds, shares and short term securities.

( ) Billions of US dollars.


In the United States, which has always been regarded as a capital market system, net withdrawal of funds from the banks amounted to US $65 billion in 1990 (Llewellyn, 1994). This suggests that not only are large US companies raising large amounts of direct finance on the capital markets (amounting to US $70 billion in 1990), but that they are also engaged in actively withdrawing funds from the banking system presumably either to finance themselves or invest in capital market instruments. In Germany, which in contrast to the US is regarded as a bank oriented system with a long tradition of close banker-customer relationships, the same trend in disintermediation, albeit on a smaller scale is taking place. This serves to emphasise that if large national and multinational companies want to compete in the World economy, they must be competitive and this means financing themselves in the most cost effective markets which are no longer necessarily traditional bank or even local domestic markets. In other words, as companies become increasingly international, their funding operations must take on an equally globalised perspective.

As large national and international companies increasingly raise finance on the World’s capital markets, the amounts borrowed from banks will continue to decline and this has significant implications for bank loan portfolios. On the assumption, made in bank pricing strategy, that large companies are usually less risky than small companies, disintermediation could have a tendency to reduce profitability and increase portfolio risk by increasing the incidence of small companies and businesses. To some extent, these considerations, combined with the structural
changes which are taking place in most western economies, explain why banks placed greater emphasis on the volumetric targeting of small businesses and the personal sector in the 1980s. The magnitude of this change is vividly put into perspective by the fact that in 1976 personal lending accounted for approximately 10 per cent of NatWest’s loan portfolio, but by 1994 this figure had increased to 40 per cent.

The commensurate emergence of the “hard-sell” in banks is not to be encouraged, especially when it is linked to salaries and payment by performance. The overheating of UK consumer demand in the late 1980s and the ensuing economic recession and record high bank debt provisioning bears testimony to this statement. Moreover, selling bank products is quite different than selling a pair of shoes or a shirt where quality is easily ascertained. In contrast, bank products can be complicated and are not readily understood even by sophisticated corporate treasurers. Consequently, there is an element of trust and responsibilities placed on banks by their customers which is not normally present in the conventional buyer-seller interchange. In contrast to the evolution of Euronote facilities, where bank and customer needs were fairly evenly matched and where the customer benefits were readily discernible, developments in derivative and other sophisticated bank corporate products do raise the question as to whether banks have misplaced this responsibility in an endeavour to simply get new business.

Many factors have affected bank performance over recent decades, in particular the erosion of the endowment element in banks profits, but the change in bank business, with its increased emphasis on small companies and personal sector lending, has arguably made commercial banks more susceptible to cyclical changes in their domestic economies. Table 3, which examines the UK commercial bank’s return on assets compared with annual growth rates in gross domestic product suggests that over the period 1984-94 bank profitability has become more closely linked to the performance of the domestic economy. Although bank performance from 1982-1986 reveals the folly of an internationally diversified portfolio in the form of excessive lending to non-OPEC LDCs, almost intuitively there does seem to be some sense in the argument that an internationally diversified portfolio, or at least a portfolio with internationally diversified customers, can allow a bank to counteract the trend in the domestic economy.
Table 3
Banks' Profits and the Economic Cycle

![Graph showing RoA and GDP Growth over years 1973 to 1993.](image)
Table 3 also reveals that UK bank profitability remained buoyant in the economic recession of the late 1970s and early 1980s. The significance of this is that it allowed the banks to continue financing fundamentally sound businesses which otherwise would have been placed into liquidation. This is in stark contrast to the recession of the late 1980s and early 1990s when bank profitability closely tracked economic performance and reduced the ability, rather than the willingness, of banks to nurture businesses through the recession. Although there are a number of other factors, changes in the profile of the bank’s loan portfolios could be an important factor in explaining why the latest economic recession was unprecedented both in terms of its severity and speed.

Another consideration, which stems from the diminished importance of large and multinational companies in commercial bank loan portfolios, is that small and medium sized enterprises assume more importance. In addition to the risk and profitability implications of this development, its importance also derives from the fact that since 1990, small businesses in the UK have been consistently losing market share to larger companies in most industrial sectors (Bank of England, 1997). Viewed in a slightly different way, this means that the small business sector’s aggregate contribution to gross domestic product is similarly declining. In this respect, therefore, it could be argued that commercial bank lending is becoming less efficient as it makes a proportionately smaller contribution to overall gross domestic product. On the other hand, small businesses in the UK make a greater contribution to employment creation than large companies and this is an important counter argument in any assessment of the efficiency of commercial bank lending.

Securitisation and the commensurate disintermediation associated with corporate wholesale finance has, therefore, a number of important implications which go far beyond wholesale banking. The considerations which have been discussed in the paper, combined with other forces which are bringing about unprecedented change in the banking industry, have seen not only commercial banks become more like investment banks, but investment banks become more like commercial banks. From the commercial banks’ perspective, however, there has been a strong imperative to develop what was traditionally regarded as “ancillary business” and so by definition the traditional core services have changed bringing about an equally marked change in income structure. Greater emphasis is now placed on fee rather than interest income, for example, in 1979, 28.6 per cent of commercial bank income in the UK
was generated from fees, but by 1995 this had increased to 43.3 per cent (BBA, 1996) and for some commercial banks, fee income is now greater than interest income.

It has been argued (Gardener and Revell, 1988) that this change in income generation increases bank risk because pricing in financial intermediation is based on the sort of cost-plus basis (shown in Figure 4) usually associated with conventional industries, whereas fee income is more susceptible to the vagaries of tendering for business. This might be the case, but it must not be forgotten that commercial banks have always found it difficult to accurately ascertain their costs and price to risk. Moreover, the change in emphasis to fee income does confer some advantages in the sense that most fees are paid upfront and this represents a “timing” advantage compared with interest income. Perhaps, however, the most important advantage associated with fee income is the fact that it is tangible and readily understood. In this respect, it affords commercial banks with an opportunity to introduce explicit pricing policies and hopefully resolve the myth of high bank charges. Finally, for large companies (and to some extent companies generally) good service is necessarily associated with a close relationship between the bank and its customer. It must not be forgotten, however, that an effective banker-customer relationship is expensive to operate and, therefore, its success is dependent upon banks extolling the very tangible advantages which banking relationships confer. This will help banks to charge appropriate fees in the knowledge that customers understand both the resource implications in providing relationship banking as well as the benefits to themselves.

**CONCLUSION**

Although there is nothing to necessarily suggest that developments in corporate wholesale banking herald the demise of commercial banking, the changes discussed in this paper do have serious implications. The paper has described and attempted an evaluation of some of the apparent changes in corporate wholesale banking and in the process has contrasted the indirect financing, associated with bank financial intermediation, with the direct financing more readily associated with capital market activity. The most pertinent conclusion from this comparison is, however, that although the discussion focusses ostensibly on banks and changes in corporate wholesale finance, the effects of these changes have been felt in a very tangible sense in other bank markets and have direct implications for society and the economy as a whole.
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RESEARCH MONOGRAPHS

No 10  Keith Pond
Do Individual Voluntary Arrangements Really Work?: A Study of IVA Durability
Publication Date: September 1993

The 1986 Insolvency Act procured the single most significant amendment to the administration of personal insolvency since Victorian times - the Individual Voluntary Arrangement (IVA).

Championed by the late Sir Kenneth Cork this flexible, contractual but essentially private procedure was designed to save “innocent” debtors from the full force of bankruptcy.

In quantitative terms IVAs have been successful since their introduction on 29 December 1986, recently enjoying a huge increase in numbers due to the economic recession in the UK.

This study charts the progress of a sample of early IVAs commenced in 1987 and 1988 using both subjective and objective measures of their success over the intervening five years. Debtor, creditors, insolvency practitioners and legislators all have different objectives in an insolvency situation and the single tool of the IVA must satisfy them all. IVAs can only be held to be successful if the aims of each interest group are achieved.

Empirical data from the sample IVAs is analysed, comparing actual and expected IVA performance in order to provide evidence regarding the achievement of IVA aims. The study also suggests that some design features of IVAs are associated more with successful than with failed cases, although much of this must be seen against the background of the economic conditions at the relevant time.

No 9  David T Llewellyn and Leigh Drake
The Economies of Bank Charges for Personal Customers
Publication Date: May 1993

The paper argues that there is an overwhelming case for bringing back charges on current accounts even when those accounts remain in credit. It recommends a two-tier pricing structure: a periodic flat rate charge to cover the fixed costs of running an account, and transaction charges which will be priced according to the true cost of different types of transaction. The quid pro quo for introducing charges would be the payment of a market rate of interest on credit balances. However, the report suggests that banks may prefer to opt for the continuation of a (smaller) hidden charge by paying less than a market rate of interest.

No 8  Dr Maximilian J B Hall
The Separation of Banking and Securities Business: A comparative study of the approaches adopted in the US and Japan
Publication Date: November 1992

The above mentioned paper discusses the following main issues:
- The US Approach to the Separation of Banking and Securities Business
- The Separation of Banking and Securities Business in Japan
- The US and Japanese Approaches Compared
- Future Reform

No 7  R D Mullett
The Legal Risks for the Lending Banker in the Provision of Secured Acquisition Finance in Highly Leveraged Acquisitions
Publication Date: December 1990

This paper identifies and analyses the main legal risks which a lending banker might encounter when financing highly leveraged transactions - the generic term used to include management buy-outs and similar transactions where high levels of borrowing are required to effect an acquisition.

The 1980s witnessed phenomenal growth in such transactions. However, with the rise in interest rates since the summer of 1988, and the problems this has brought, several highly leveraged acquisitions have demonstrated quite clearly the legal risks involved. These risks were in evidence at the initiation of the transaction but were only quantified and faced later on.

Four categories of risks are considered, relating to: the memorandum and articles of association of both the acquiring and target companies; the terms of the 1986 Insolvency Act; the company law restrictions on the provision of financial assistance for the acquisition of a company; and the declaration of an offer as unconditional. The paper concludes with three relevant case studies.

Richard Mullett, who is currently qualifying as a solicitor, undertook his research in this area while at Loughborough University. In addition to those with research interests in banking and corporate finance, the paper will be a valuable aide-mémoire to anyone concerned with the financing of management buy-outs and similar transactions, whether in commercial banks, merchant banks, securities houses, venture capital companies or accountancy firms.
No 6  
Bob Lee and Judith Piper  
Managerial Promotion Processes in TSB  
Publication Date: October 1989

This research examines the dynamics of the promotion process within the Trustee Savings Bank. The study explores the "formal" and the "informal" promotion processes from both the "promoters" and the "promotees" perspective. The research examines in detail the beliefs, attitudes, perceptions and consequent behaviour of the organisation's members. The dichotomies between the two groups are explained by a conceptual model of "official" and "unofficial" organisational culture.

The expanding management literature and research in this area demonstrates a growing concern to understand what is perceived by many as a critical organisational issue. Its significance is further underlined by the climate of declining opportunities for advancement and the onset of early and widespread career plateauing.

The research begins with an analysis of the organisation's "formal" promotion systems and processes and contrasts them with the "informal" processes. The study is grounded within the specific cultural context of TSB. The political dimension of the promotion process is also studied from the perception of different members of the organisation. The issues of gender, "labelling" and "mentoring" are among those considered.

The development of a conceptual model that contrasts the "perceived" promotion environment with that of a "desired" promotion environment provides human resource managers with a framework to understand the intricacies of promotion processes and their consequent effects upon individuals and ultimately organisational performances. During times of slow growth, issues of motivation and retention of personnel are vital to organisational health.

No 5  
Keith Pond  
An Alternative to Bankruptcy - An Empirical Study of Individual Voluntary Arrangements  
Publication Date: July 1989

Society's changing attitude to debt was reflected in the 1982 review of Insolvency Law by Sir Kenneth Cork and his committee. Bankruptcy was not the way to deal with many "innocent" debtors. Individual Voluntary Arrangements (IVAs) sought both to overcome the legal problems which had dogged previous attempts to find alternatives to bankruptcy and to allow debtors and their creditors to come to terms with each other apart from an air of acrimony. Cork's proposals for IVAs became law in the Insolvency Act 1986 and have been available since 29 December 1986.

This is the first full-scale empirical study of IVAs and covers the first 18 months of the new legislation.

The study includes:
- A review of the impact of IVA, their low uptake and the apparent resistance to the new legislation.
- An empirical analysis of a representative national sample of IVA cases, including a detailed examination of IVA design features.
- A detailed analysis of creditor attitudes and voting behaviour, together with a search for definite clues to the acceptability, or otherwise, of a debtor's plans.
- A practical review of the law relating to IVAs, which incorporates suggestions for improvements to be made so that some barriers to IVAs can be overcome.
- A follow-up study of IVAs in action, at their statutory 12 month review stage.

The monograph contains information of interest to insolvency practitioners, debtors, court officials, solicitors, citizens advice bureaux as well as credit controllers, banks and building societies.

As IVAs become more accepted as an alternative to bankruptcy it will be essential for advisors and credit providers to be aware of this subject.

No 4  
Martin Glaum  
The Management of Foreign Exchange Risk in Multinational Corporations  
Publication Date: October 1985

Only some 15 or 20 years ago the subject of foreign exchange risk management was considered arcane and of minor importance to corporate management. This attitude has changed drastically. With today's volatile foreign exchange markets and the increased internationalisation of business, exchange risk management is now generally accepted to be one of the most important tasks of corporate financial management.

The author argues that the current literature on foreign exchange risk management has two shortcomings. Firstly, as the majority of publications have emerged over a relatively short period of time, no clear and accepted terminology has yet evolved. A confusing variety of terms are used by different authors to describe the same matters.

Secondly, most of the literature is concerned only with the tactical aspects of exchange risk management. This short-term orientation mostly lacks a sound economic foundation and it fails to incorporate the important long-term implications exchange rate changes can have on a company's overall competitive situation.

The monograph addresses the shortcomings identified above. It presents a comprehensive taxonomic and economic framework for the analysis of the relevant questions of corporate exchange risk management.

The monograph consists of three parts:
- In the first part the term "exchange risk" itself is defined and the merits of different concepts of foreign exchange exposures are critically discussed.
- The second part puts the questions of corporate exchange risk management into a broad economic framework. Here it is asked whether foreign exchange risk really exists and, if so, whether there is a need for companies to manage it actively.
Part three presents and explains the various techniques and instruments available to the corporate exchange risk manager. This section is divided into two parts, the first of which concentrates on techniques for the strategic management of exchange risk; the second part presents the more conventional tools for tactical exchange risk management, including some financial innovations such as currency futures, options and swaps.

The monograph is roughly 100 pages long; it makes use of diagrams and tables in order to explain and summarise. It also contains an extensive bibliography of the current international literature on the foreign exchange risk management.

No 3  Leigh Drake & David T Llewellyn
Capital Requirements for Building Societies: Implications for Interest Rates, Profitability and Competitive Neutrality
Publication Date: July 1987

There are strong links between capital and profitability and this monograph provides a detailed analysis of this inter-relationship in the light of the recent prudential guidelines on capital adequacy issued by the Building Societies Commission.

The monograph consists of:
- A detailed assessment of the market environment within which building societies operate.
- An analysis of the competitive structure as between banks and building societies and the implications of the limited diversification permitted under the 1986 Building Societies Act.
- An examination of recent trends in building society profitability.
- A discussion of the need for capital, the generation of capital by building societies and the relationship between capital and profitability.
- A review of the new prudential requirements on capital adequacy for building societies.
- A formal analysis of the interest rate and interest spread implications of the new capital requirements, and examination of their impact on the future competitive position of building societies vis-à-vis banks.

No 2  Leigh Drake & David T Llewellyn
Publication Date: July 1987

This monograph addresses an issue which has thus far been neglected, both academically and within the building society industry: namely, the profitability of building societies. The monograph argues that for a number of reasons (including their mutual status) the profitability of building societies has not been systematically analysed. The reasons for this neglect, however, are much less powerful than they once were. Increased competition, both in the retail savings market and in the mortgage market, the blurring of the boundaries between different financial institutions, the recent Building Societies Act and Capital Adequacy Requirements and the possibility of conversion to plc status in the near future, are all factors forcing building societies to become more profit orientated than in the past.

The monograph consists of:
- A systematic analysis of the analytical structure of building society profitability.
- A detailed historical perspective of the financial performance of the Halifax Building Society as a case study.
- A theoretical analysis of the interest rate setting procedure adopted by building societies in the 1970s and the identification of a structural change in the early 1980s.

No 1  Bob Lee & Judy Piper
Managerial Promotion Processes
Publication Date: June 1987

This research project highlights the significance of the need to understand promotion processes within organisations, notably because of the centrality of promotion to the lives of most managers. The study offers a unique insight into the attitudes, perceptions and behaviours of managers/potential managers in a major clearing bank with regard to the organisation's promotion processes.

The prevailing business climate of declining opportunities for advancement in much of the financial services sector combined with the undoubted importance of promotion for many managers provides the backdrop for this research project.

The starting point for the analysis is the organisation's formal promotion system. The study examines the relationship between the range of promotion systems and promotion processes and relates these to the specific cultural milieu. This is the context within which the study is set.

The development of a conceptual framework as a way of understanding promotion processes provides not only the groundwork for other researchers in this field, but provides human resource managers with a framework for analysing and appraising the richness and complexity of promotion processes and their effects upon individuals and ultimately organisations.