In partnership with: City of London | UK Trade & Investment

International Financial Services London — Promoting UK financial services throughout the world

IFSL RESEARCH

BANKING 2010

FEBRUARY 2010 | WWW.IFSL.ORG.UK

SUMMARY

This IFSL report gives an overview of the UK banking sector and sets out its importance in an international context. The global banking system has been affected by a significant re-pricing of credit risk and a liquidity squeeze since the second half of 2007. Systemic risks have been reduced following policy actions and signs of improvement in the global economy. Further risks however remain and the banking system is expected to deal with additional write-downs, government bailout repayments and challenging market conditions in the coming years.

International comparisons Assets of the largest 1,000 banks grew by 6.8% in 2008/2009 to a record $96.4 trillion while profits declined 85% during the year to $115bn (Chart 1). Growth in assets in adverse market conditions was largely a result of recapitalisation. In addition to government support, around $1 trillion was raised by banks through capital markets between the start of the credit crisis and first half of 2009. The International Monetary Fund estimates that more than $1.3 trillion in bad loans was written off during this period with additional writedowns of $1.5 trillion possible over the next few years (Chart 2).

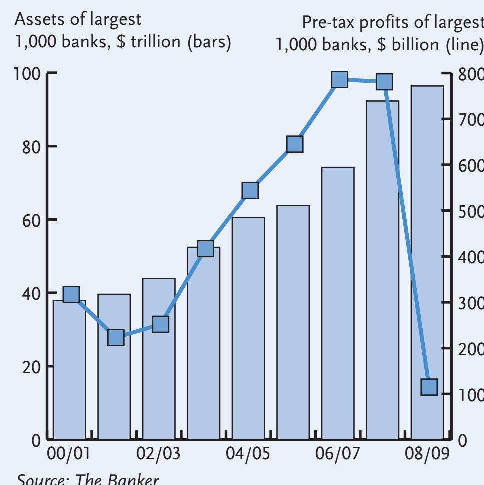
Investment banking fee revenue totalled $66bn in 2009, up 12% on the previous year but down a fifth on the 2007 total. Growth in fund raising through capital markets, the recovery in equity markets and high trading volumes helped to increase global investment banks' revenue. The US accounted for 46% of fee revenue and Europe a third. The UK is the source of around a quarter of European fee revenue, and about a half of European investment banking activity is conducted through London.

UK banking industry assets totalled £7,616bn at the end of 2009, down 4% on the previous year. Foreign banks held 51% of the total. As concerns about solvency eased, UK banks' equity prices rose by 40% between March 2009 and the end of the year, recouping much of the losses of the previous nine months. Liquidity remains strained although the banking system was significantly more stable in the latter part of 2009. Over the next five years, UK banks will need to refinance over £1 trillion of wholesale funding, including funding that has been supported by the public sector.

The UK remains one of the leading centres for banking. Its deposits are the third largest in the world after the US and Japan and it has the largest share of cross-border bank lending (18%). The 249 foreign banks physically located in the UK is more than in any other centre. The UK is also one of the most important centres for private and investment banking.

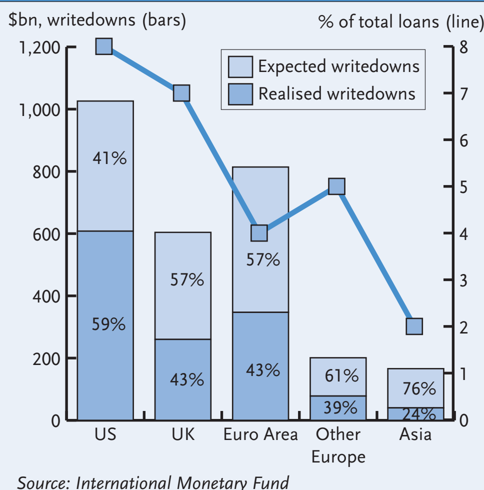
Contribution to the UK economy Net exports of UK banks totalled a record £31bn in 2008, up 31% on the previous year. The UK banking industry contributed £58bn to the UK economy in 2007, equivalent to 4.7% of GDP, or over half of the 8.3% generated by the financial sector as a whole. Banks located in the UK provided employment for 435,000 people in 2008.

Chart 1 Worldwide banking industry assets and profits



Source: The Banker

Chart 2 Realised and expected writedowns for banks by region, June 2009



Source: International Monetary Fund

CONTENTS

	Page
Summary	**1**
International banking market	**2**
Investment and private banking	**8**
The UK banking industry	**12**
Contribution to the UK economy	**18**

INTERNATIONAL BANKING MARKET

Global capital markets have been affected by a significant re-pricing of credit risk and a liquidity squeeze since the second half of 2007. While the financial crisis originated in the US, financial institutions around the world have been affected by losses related to subprime mortgage investments. The International Monetary Fund (IMF) estimates that more than $1.3 trillion in bad loans was written off between 2007 and first half of 2009 with additional writedowns of $1.5 trillion expected over the next few years. US bank writedowns are likely to account for $1 trillion of the $2.8 trillion total and European banks for $1.6 trillion. Up to the June 2009 US banks recognized about 60% of their sub-prime related losses, more than the 40% recognised on average in European countries. Writedowns are likely to account for around 8.2% of overall holdings of loans and securities by banks in the US, 7.2% in the UK and 3.6% in Euro area banks according to the IMF (Chart 2).

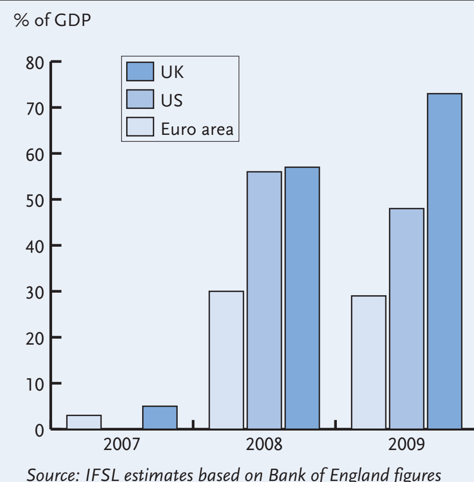
Central banks around the world have taken substantial interventions (Chart 3) to increase liquidity in their banking systems through various measures such as monetary policy actions, guaranteeing bank liabilities and recapitalisation. In the fourth quarter of 2008 alone, central banks around the world purchased more than $2.5 trillion of government debt and impaired private assets. Governments have also raised the capital of their banking systems by $1.5 trillion by purchasing newly issued preferred stock in their major banks. International regulators are seeking to establish new rules that will make future financial crises less likely and the financial system more resilient. Systemic risks have been reduced following policy actions and signs of improvement in the global economy. This has relieved the immediate pressure to deal with some of the toxic assets. Liquidity however remains strained. Further risks remain and the banking system is expected to deal with additional write-downs, government bailout repayments and challenging market conditions in the coming years.

Largest banking centres

Worldwide assets of the largest 1,000 banks grew by 6.8% in 2008/2009 to a record $96.4 trillion (Chart 1). Assets of the largest 1,000 banks had more than doubled in the five years leading up to the start of credit crisis in 2007. EU banks held the largest share of global bank assets, 56% in 2008/2009, down from 61% in the previous year. Asian banks' share increased from 12% to 14% during the year, while the share of US banks increased from 11% to 13%.

Growth in assets during the 2008/09 financial year in adverse market conditions was largely due to recapitalisation, often with government support. Central banks around the world have taken unprecedented support measures in an effort to boost liquidity. More than $200bn in new capital was injected into the top 20 banks alone. With regulators requiring banks to increase their capital base, there has also been a great deal of issuance activity on capital markets. Globally, banks raised nearly $1 trillion in new capital between the start of the credit crisis and first half of 2009. US banks

Chart 3 Public sector interventions during the credit crisis

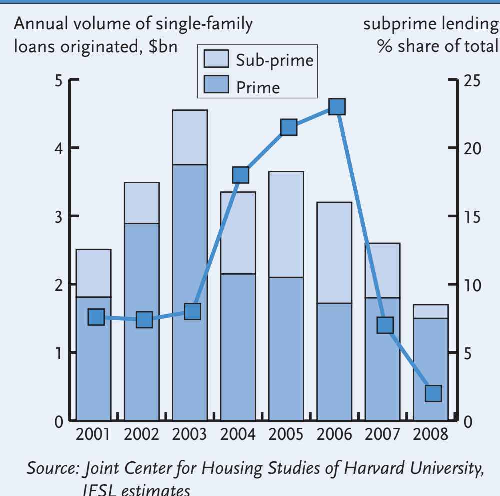


Source: IFSL estimates based on Bank of England figures

Chart 4 Global banks' capital raising

Source: IMF

Chart 5 US mortgage lending



Source: Joint Center for Housing Studies of Harvard University, IFSL estimates

raised nearly a half of this total. Europe followed with nearly $400bn. As a result the Tier 1 capital to assets ratio increased to 4.43% in 2008/09 from 4.32% a year earlier. The ratio is likely to increase further as a result of global regulation changes which are likely to include higher capital requirements and tighter liquidity rules.

UK banking sector deposits are the third largest in the world and the largest in Europe. According to the latest available international comparisons, UK banks' deposits totalled $5.4 trillion at the end of 2008. The US held the top position with $8.1 trillion, followed by Japan $6.6 trillion. The UK's position is largely a reflection of the international character of its banking sector as more than half of its banking sector assets are foreign owned. Other European countries with substantial deposits include Germany, France, Switzerland and Italy (Chart 8).

The US has by far the most banks and branches in the world (Table 1). The large number of banks in the US is an indicator of its geographical dispersity and regulatory structure resulting in a large number of small to medium sized institutions in its banking system. In Western Europe, Germany, France and Italy have around 30,000 branches each. This was nearly three times the number of branches in the UK. Germany has the highest number of registered banks and the most employees.

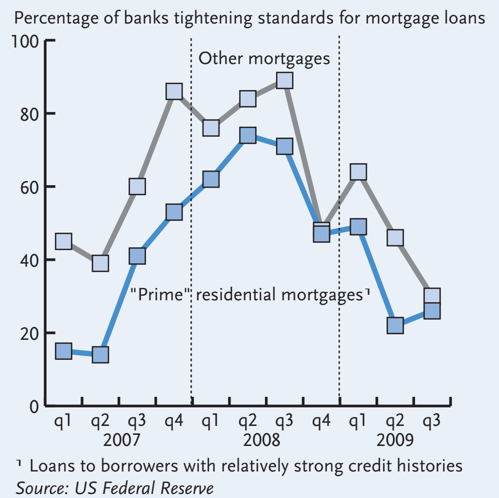
The sub-prime crisis

The causes of the sub-prime banking crisis were varied and included global economic imbalances leading to excess liquidity, low real interest rates, a search for yield, and the rise in complex financial instruments. Traditionally banks financed mortgage lending through customer deposits. This limited the amount of mortgage lending they could do. Since the start of this decade, banks moved to a new model where they sold on mortgages to bond markets in order to raise additional capital. Sub-prime mortgage loans or loans to borrowers with poor credit histories and weak documentation of income captured a growing share of US mortgage lending over the past decade (Charts 5 and 6). Through securitisation, many of these loans were transferred to mortgage backed securities (MBS). These securities were then rated by rating institutions such as Moody's, S&P, etc. In addition MBS were sold on to investors through collateralised debt obligations and structured investment vehicles. In this way, mortgage lenders had passed on the risks of sub-prime lending to third-party investors such as pension funds, hedge funds, investment banks and insurance companies. Many European banks had holdings of such securities.

Beginning in late 2006, many sub-prime mortgages in the US became default as homeowners ran into financial difficulties following a series of interest rate rises and a fall in house prices. As borrowers became unable to make payments, there were losses and downgrades on related asset-backed securities and other structured instruments. The value of markets for asset-backed securities fell and wholesale banks became reluctant to grant banks and mortgage providers new loans or did so at much higher interest rates. The bond market for mortgages became less liquid, and the ability of banks to obtain funds through the wholesale market became restricted.

As global interbank markets seized up restricting banks from accessing short-term funding, central banks, as the "lenders of last resort" responded with large-scale injections of liquidity followed by other actions. Losses incurred by financial institutions, and the reduction of liquidity fed in to the wider economy and placed downward pressure on global economic growth. The reduction in willingness of banks to loan funds to other banks and customers, resulted in a decrease in investments by businesses and a reduction in consumer spending. Following interventions by central banks and goverments around the world, over the past two years liquidity in interbank markets has gradually improved.

Chart 6 Banks tightening standards for loans

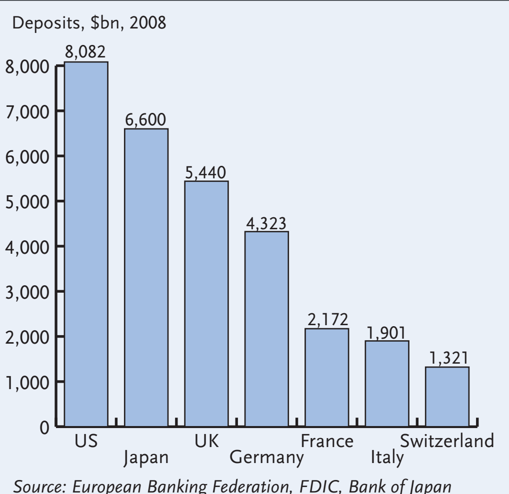


¹ Loans to borrowers with relatively strong credit histories
Source: US Federal Reserve

Chart 7 Regional breakdown of largest 1,000 banks

Source: The Banker

Chart 8 Largest banking centres



Source: European Banking Federation, FDIC, Bank of Japan

Comparisons of bank profitability Pre-tax profits of the world's largest 1,000 banks fell by 85% in the 2008/2009 financial year to $115bn from $781bn in the previous year. This follows 10% annual profit growth over the past decade, largely a result of strong lending growth and low credit losses. Average global return on capital (pre-tax profits to Tier 1 capital) fell to 2.69% in 2008/09, from 20.02% in the previous year (Chart 9). For the first time the largest 25 banks which account for around 40% of the Top 1,000 assets recorded a net loss which totalled over £30bn.

On a regional basis, US banks reported the largest annual loss in 2008/09 while Chinese and Spanish banks headed the rankings for best profit performance. According to The Banker magazine, the UK's Royal Bank of Scotland reported the highest loss in 2008/09 at $59bn, followed by two US banks, Citigroup $53bn and Wells Fargo & Co. $48bn. Banks which were largely domestic and less involved in securitised loans were much less affected.

The relative importance of Asian banks has increased since the start of the credit crisis. Asian banks put in the best performance in the 2008/09 financial year (Table 2) with reported profits of over $160bn. Chinese banks generated profits of $84bn and Japanese $16bn. US banks reported the highest losses, $91bn. They were followed by UK banks with aggregate losses of some $51bn and other EU countries $16bn. Although some UK banks remained profitable during the year, the negative aggregate total was partly due to large losses reported by the Royal Bank of Scotland and HBOS. Middle Eastern banks performed well despite the drop in oil price and remained profitable during the year. Latin American banks also put in a positive performance.

Bank profitability improved in 2009, a result of heavy capital market trading, debt and equity underwriting business, and mortgage refinancing activity. According to Bank of England statistics, large global banks (comprised of 25 of major UK and international banks) reported pre-tax pre-provision profits of $200bn in the first half of the year, compared with $56bn during 2008. Over half of the revenues were related to non-interest income. The rise in asset prices also reduced write-downs. Large global banks wrote off some $30bn in the first half of 2009, compared with $210bn for the whole of 2008.

Loan-to-deposit ratios have become a more important indicator of liquidity during the financial slowdown. Banks with lower loan-to-deposit ratios were in a much stronger position than banks that relied more heavily on wholesale capital market funding. Banks in the EU and 'rest of Europe' had the highest average loan-to-deposit ratios in 2008/09 121% and 112% respectively, against a global average of 104%. This means that European banks were more dependent on wholesale capital market funding than banks from other regions. In the US the ratio totalled 100%, in Japan 76% and in the rest of Asia 85%.

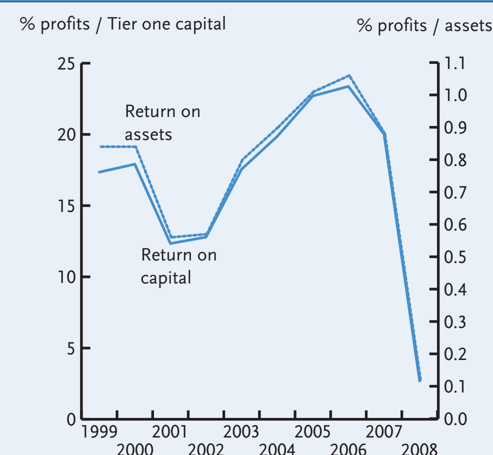
The cost/income ratio is another important indicator of banking efficiency, measuring banks' operating costs as a proportion of total income. The higher the ratio the more inefficient the bank is deemed to be. According to this measure the cost/income ratio in the US totalled 72% in 2008/09 up on the

Table 1 Number of banks and branches in largest banking centres

end-2008	Number of banks	Number of branches
US	7,085	82,547
Germany	2,169	39,565
Italy	799	34,146
France	394	27,875
Switz.	327	3,488
UK	324	10,300
Japan	150	12,000

Source: European Banking Federation, US Federal Reserve, Bank of Japan, Financial Services Authority

Chart 9 Return on capital and assets in all banks



Source: The Banker

Table 2 Regional breakdown of pre-tax profits

$bn	2007/2008	2008/2009
Asia (excl. Japan)	148	146
Middle East	31	23
Latin America	31	17
Japan	55	16
Rest of Europe	55	-8
EU27	320	-16
US	109	-91
Rest of world	39	28
Total	**781**	**115**

Source: The Banker

Changes in regulation

The economic crisis has prompted governments around the world to re-evaluate their financial regulatory frameworks. The objectives have been to contain and reverse the stress in financial markets through liquidity provision and cleansing banks' balance sheets of impaired assets. This was done through various policy measures including: monetary policy actions such as reductions in interest rates and quantitative easing, liquidity injections, credit easing through purchases of credit instruments, guaranteeing bank liabilities and injecting capital into financial institutions.

At the outset of the credit crisis attention turned to recapitalisation and the insurance of bank transactions. Differing country circumstances spurred a wide variety of approaches. The UK introduced a Special Liquidity Scheme to allow UK banks to swap illiquid assets against UK Treasury bills. The UK Government has also made direct equity investments in a number of banks. The French plan included programs to provide financing and equity capital to French institutions in return for commitments to ease access to loans. Germany established a Financial Market Stabilization Fund, designed to stabilize the financial system by helping to overcome existing liquidity shortages and strengthen financial institutions' equity base. The European Commission has proposed an overhaul of Europe's system for supervising banks that places an emphasis on both micro-prudential and macro-prudential supervision to oversee both individual institutions and the overall banking framework.

In the US, the Government announced its Financial Stability Plan in 2009 which continued the programs initiated by the Troubled Assets Relief Program, such as the Capital Purchase Program, and initiated additional programs, including the Capital Assistance Program and the Public-Private Investment Program. In addition, the Federal Reserve has undertaken a variety of other programs intended to stabilize the financial system and revive lending in key sectors of the economy. The US Government has proposed reforms to the regulation of the financial system that would give the Federal Reserve greater supervisory authority over any institution that may pose a threat to the financial system. New systemic risk powers for the Fed would be accompanied by tougher capital requirements for banks, particularly large banks.

Proposals under consideration by the Basel Committee on Banking Supervision, made up of central bankers and regulators from 27 countries, include higher capital requirements and global liquidity rules and measures that would limit banks' ability to pay out dividents and bonuses when their capital rations are too close to regulatory minimums. Banks will also be required to build up their capital during lending booms, in preparation for extra losses. The Basel Committee is also looking into whether the largest global banks should be required to hold more capital and liquid assets such as cash and government bonds. The rules are expected to go into effect by 2012 but could be delayed if regulators conclude they would impede broad economic recovery.

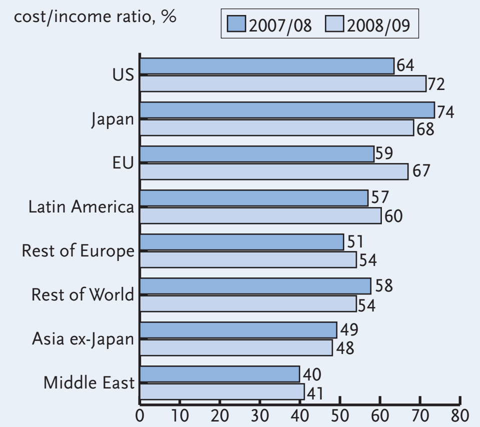
previous year's 64%. Japanese banks position improved during the year from 74% to 68%. EU banks on the other hand saw a deterioration from 59% to 67% as did most other regions apart from Asia (Chart 10).

Cross-border banking

International lending and borrowing BIS figures estimate the total outstanding value of cross-border lending at $34,008bn in June 2009. The $477bn decline in gross international claims of BIS reporting banks in Q2-2009 was considerably smaller than the $1.1 trillion and $1.9 trillion reductions registered in the prior two quarters but was still the fourth largest fall in the past decade (Chart 11). The shrinkage in international balance sheets since the collapse of Lehman Brothers was driven by a contraction in interbank claims and a retrenchment from foreign markets in order to concentrate on domestic markets. This followed a prolonged period of expansion as the global banking system became more interconnected.

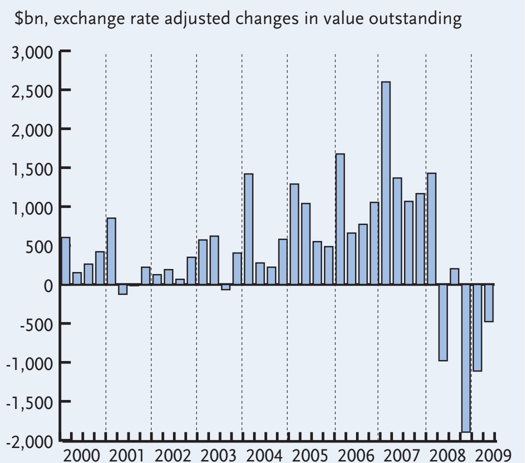
The UK, with 18% of international bank lending in June 2009 (Chart 12), was the largest single market for cross-border banking business, its share

Chart 10 Average cost/income ratio by region



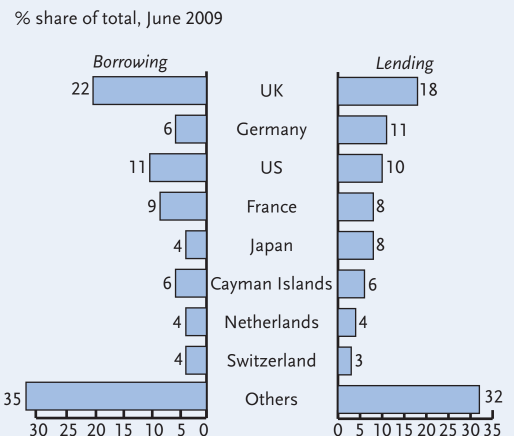
Source: The Banker

Chart 11 International bank lending flow



Source: Bank for International Settlements

Chart 12 Origin of cross-border transactions



Source: Bank for International Settlements

Offshoring involves companies relocating a business process from their home market to another country. This has been a growing trend in the decade up to the start of the credit crisis. The rapid growth in offshoring slowed in 2008 and 2009, despite the fact that the trend of high wage inflation in offshoring markets diminished. Cost containment in challenging market conditions may prompt companies to outsource more activities in next few years. Since the mid-1990s, technological developments and a fall in telecommunications costs have allowed for greater independence of operations from market-place. As a result, the range of business processes that may be considered for outsourcing and offshoring has broadened. Functions which are typically offshored include software and hardware development, customer support and IT services. India is the most popular destination for offshoring, with Asia as a whole being the largest regional destination. The offshoring market is dominated by US companies which account for 70% of offshoring activity. European and Japanese companies make up most of the remainder, with the UK being a dominant player in Europe.

having declined from around 20% two years earlier. Germany, with 11%, had the second largest share. Elsewhere, market share remained relatively stable with offshore banking centres retaining around a fifth of banking flows. The most important borrowers in the global lending market are industrialised countries. The UK had the largest share with 22% of the total, followed by the US with 11%, and France with 9%.

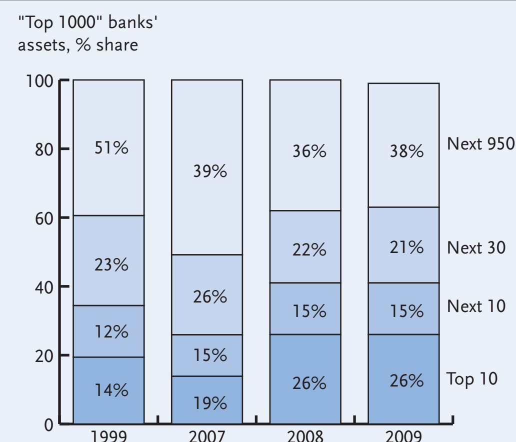
The international character of the UK market for cross border lending is reflected in the range of countries represented there and the spread of currencies. The most active banks in cross border banking located in the UK are UK-owned, followed by German, Swiss and US banks. The dominant currencies are the US dollar and euro, each with around 40% of cross border lending, followed by sterling with 7%.

Number of foreign banks Statistics on the number of foreign banks reveal that London remains the most popular centre with 249 foreign banks located there in March 2009. The next most popular location was New York, with around 200 foreign branches and representative offices. The smaller number of foreign banks in New York is largely an indicator of the nature of the US banking industry which is more oriented towards serving the domestic market.

Largest global banks

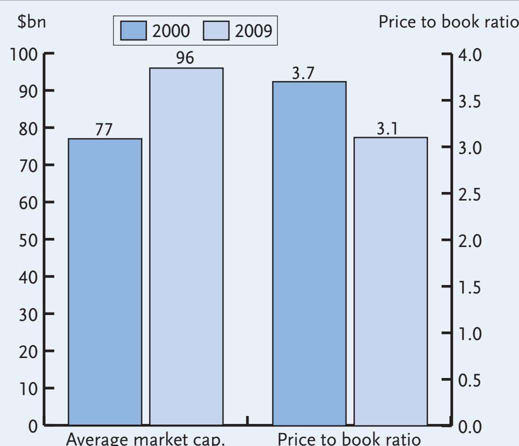
Despite the financial difficulties, the largest 25 banks list is composed of largely the same institutions as in the previous year, dominated by Western banks and a few Japanese and Chinese players. US banks, which reported more than $600bn in losses since the start of the credit crisis headed the rankings in terms of Tier 1 capital and assets. In 2008/09, JP Morgan Chase & Co climbed to the top spot following its takeover of Bear Sterns and Washington Mutual (Table 3). Bank of America followed in second place with its acquisition of Merrill Lynch while Citigroup was in third place. The UK's Royal Bank of Scotland and HSBC Holdings were in fourth and fifth place. Wells Fargo's acquisition of Wachovia enabled it to climb to sixth place from 23rd. Countries with most banks among the Top 1000 were the US 159 (down from 169 in the previous year), Japan 97 (down from 98) and Germany 88 (up from 81). The UK had 23 (down from 27). Chinese banks are gradually gaining in strength with three Chinese banks in the top 12 in the latest rankings.

Chart 13 Concentration of global banking



Source: The Banker

Chart 14 Most highly valued banks[1]



[1] Average of top 10 banks by price to book ratio
Source: Financial Times

Table 3 Largest banks in the world

$bn, 2008/09			Tier one capital Total	Tier one capital excl. gov capital	Govern. injection
1	JP Morgan Chase & Co	US	136.1	111.1	25
2	Bank of America Corp.	US	120.8	105.8	15
3	Citigroup	US	118.8	73.7	45
4	Royal Bank of Scotland	UK	101.8	71.9	30
5	HSBC Holdings	UK	95.3	95.3	0
6	Wells Fargo & Co	US	86.4	61.4	25
7	Mitsubishi UFJ Financial Group	Japan	77.2	77.2	0
8	ICBC	China	74.7	74.7	0
9	Credit Agricole Group	France	71.7	67.5	4
10	Santander Central Hispano	Spain	65.3	65.3	0
11	Bank of China	China	65.0	65.0	0
12	China Construction Bank Corp	China	63.1	63.1	0
13	Goldman Sachs	US	62.6	52.6	10
14	BNP Paribas	France	58.2	54.6	4
15	Barclays Bank	UK	54.3	54.3	0

Source: The Banker

Liberalisation

There has been a global trend towards autonomous liberalisation in banking and other financial services sectors, particularly in developing countries. However, numerous barriers to international trade in financial services remain in place. A sectoral agreement in financial services was concluded in the WTO in 1997 but the liberalisation commitments made by participating countries at that time were based largely on the status quo. That agreement, therefore, did little to ease the restrictions that exist in the financial services sector. The current round of WTO negotiations was launched at Doha in 2001. A consequence of the slow progress in negotiations was the resurgence of regional trade agreements where countries give each other preferential treatment in trade by eliminating tariffs and other barriers on goods. The EU is pursuing targeted bilateral trade agreements as part of a wider EU strategy centred on the WTO and the multilateral trading system. In 2007, the EU launched negotiations on free trade agreements with Korea, ASEAN countries and India. More recently it has announced that it will launch negotiations with Singapore. A second round of negotiations between EU and Canada was held in January 2010.

Banks' business has become more global, facilitated by the reduction in barriers to international trade and technological developments. As a result of consolidation, the share of assets of the largest ten global banks grew from 14% in 1999 to 26% in 2008 (Chart 13). The share of the next forty banks rose slightly during this period while the share of the remaining 950 banks decreased from 51% to 38%. Further consolidation is likely, especially in Continental Europe with the banking sector in Germany, France and Italy being more fragmented than in the UK. Competition has been intensified by new players such as internet banks and institutions whose parent companies are not part of the traditional banking sector such as supermarket banks and insurance companies.

Price-to-book ratio shows a bank's share price as a multiple of its book value. In the six years to end-2009, the average price-to-book value of the biggest 10 banks declined from 3.7 to 3.1 (Chart 14). During this period the average price-to-book ratio of the biggest 50 banks halved from 2 to 1. This indicates that investors were on average valuing banks at their balance sheet values at the end of 2009. At the start of the decade US banks dominated price-to-book ratio rankings. Chinese banks doubled in valuation during 2009 and held the top three spots in the rankings at the end of the year. This is a reflection of growing confidence in emerging markets, particularly in China and Brazil.

In terms of market capitalisation Industrial and Commercial Bank of China, China Construction Bank and Bank of China held the top three spots with market capitalisation exceeding $100bn in March 2009 (Chart 15). They were followed by HSBC bank and JP Morgan Chase. A decade ago, the rankings were dominated by banks from the US and UK. In 2009 only four of the top 20 banks were headquartered in the US. Citigroup which dominated the rankings for most of the past decade fell to 46th place in 2009 following losses sustained on sub-prime mortgage investments and the subsequent US Government bailout. Its market capitalisation fell from $217bn in Q2-2007 to $19bn in January 2009 (Table 4). Many other banks are still trading well below their asset values despite a recovery in equity markets during 2009.

Chart 15 Largest global banks by market capitalisation

$bn, March 2009

Source: Financial Times

Table 4 Shrinkage of market capitalisation of major banks

$bn, Q2-2007 to January 2009

	Q2-2007	Jan-2009	*% decline*
RBS	110	5	*96*
Citigroup	217	19	*92*
Barclays	77	7	*92*
Deutsche Bank	56	10	*85*
Credit Agricole	33	15	*64*
Unicredit	38	26	*60*
BNP Paribas	44	32	*58*
UBS	46	35	*57*
Societe Generale	28	26	*52*
Morgan Stanley	17	16	*52*

Source: Bloomberg

INVESTMENT AND PRIVATE BANKING

Size of the investment banking industry

Global investment banking revenue totalled $66bn in 2009, up 12% on the previous year but over a fifth down on record fees earned in 2007 (Chart 16). Growth in fund raising through capital markets, the recovery in equity markets along with high trading volumes helped to increase global investment banks' revenue. This follows a very difficult year for the industry during which some investment banks suffered from large trading losses and unprecedented writedowns. Many investment banks posted large profits in 2009 as they were not faced with trading losses and write-downs to the same extent as in the previous two years. Goldman Sachs for example posted profits of £13.4bn in 2009, compared with £2.3bn in the previous year.

The US accounted for 46% of total investment banking revenue in 2009, down from 56% a decade earlier. Europe accounted for nearly a third of the total, a proportion which has remained relatively stable during this period. Asian countries on the other hand increased their share from 14% to 21%.

Although the UK was the source of 24% of European investment banking fee revenue in 2009, around a half of European investment banking activity was conducted through London. The majority of investment banks are either headquartered or have a major office there. The largest international banks in London each employ several thousand people.

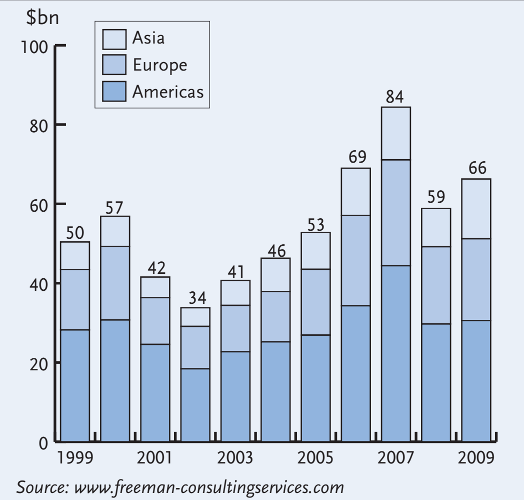
As market conditions improve, investment banks will not be able to rely to the same extent on fees generated by financial restructuring. Regulatory changes may bring stricter conditions with respect to capital costs and liquidity requirements. On the other hand, a low interest rate environment, along with an increase in corporate confidence and less volatile markets, should help to facilitate a pickup in M&A activity. Commodities trading in emerging markets and continuing industrialisation of China and other Asian countries as well as funds from the Middle East are likely to become a more important source of investment banks' business in the coming years.

Investment banks' business

Most investment banks' work is undertaken on behalf of large companies, banks and government organisations with some also providing a service to wealthy individuals. A number of investment banks, particularly from the US, have expanded into the retail sector while at the same time some commercial banks through mergers and acquisitions have increased their presence in investment banking.

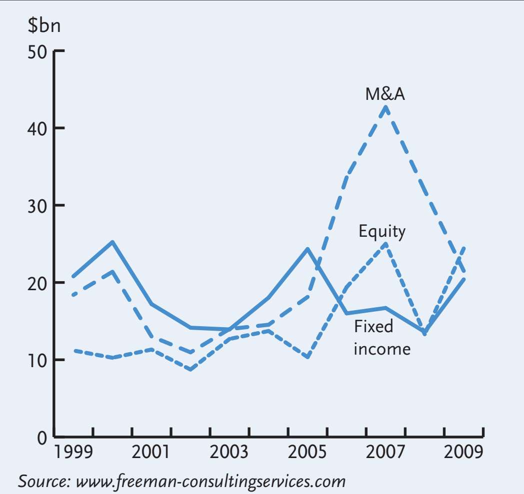
Investment banks' business can broadly be categorised into: corporate finance and advisory work, treasury dealing, investment management and securities trading. Only a few investment banks provide services in all these areas. Most others tend to specialise to some degree and concentrate on a few product lines. A number of banks have diversified their range of services by developing businesses such as proprietary trading, servicing hedge funds or making private equity investments.

Chart 16 Global investment banking sources of revenue by region



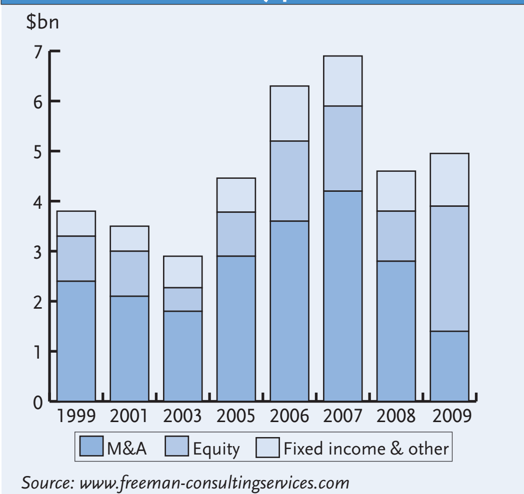
Source: www.freeman-consultingservices.com

Chart 17 Global investment banking sources of revenue by product



Source: www.freeman-consultingservices.com

Chart 18 UK investment banking sources of revenue by product



Source: www.freeman-consultingservices.com

Product breakdown Equity underwriting, fixed income underwriting and mergers and acquisitions (M&A) business each accounted for around a third of total fee revenue in 2009 (Chart 17). As a proportion of total revenue M&A has fallen considerably since the start of the economic crisis while other areas of investment banking have increased.

M&A advisory had been the main source of fee income in the decade prior to the current economic slowdown, typically generating more than 40% of investment banks' revenue. M&A activity has however declined markedly since the start of the financial crisis. Fees from M&A advisory work totalled $21.5bn, or 32% of total fee revenue in 2009, down on its 52% share in the previous year. UK investment banking also saw a drop in revenue from M&A work in 2009 from 61% to 28% of the total or around $1.4bn (Chart 18).

Announced corporate mergers and acquisitions fell by 28% in 2009 to $2.1 trillion. This was the lowest level since 2003 and down by a half on the record $4.2bn in M&As announced in 2007 (Chart 19). By number of deals, M&A activity is down just 6.6% compared to the previous year with over 38,000 announced deals. The US generated 44% of deal volume, up on its 40% share in the previous year. Activity in Europe nearly halved during the year to $580bn. UK activity accounted for a quarter of Europe's total.

Equity underwriting generated $24.4bn or 37% of investment banks' fee revenue in 2009. The proportion of investment banks' income originating from equity underwriting has ranged between 30% and 38% over the past decade. The failure of a number of investment banks during 2008 has enabled other banks to raise prices. For example the fees charged for corporate rights issues in the UK grew to 3.5% in 2009 from an average of 1.8% in the previous year.

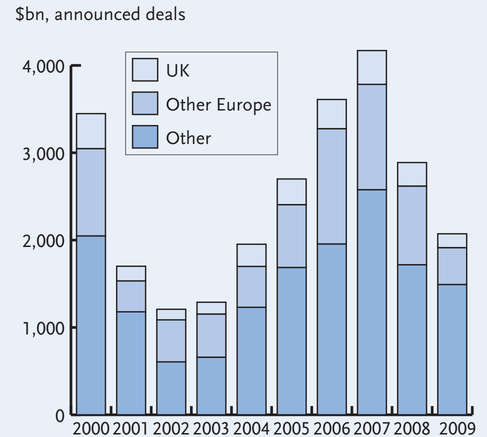
Fixed income underwriting accounted for 31% of total investment banking fee revenue in 2009 or $20.4bn. This was significantly up on its 19% share in the previous year. As with equity underwriting, fees charged for fixed income underwriting have also increased. For example margins on European government bond sales have increased between 25% and 50% on the previous year.

Despite a 3% drop in its share to 30% in 2009, the financial sector, with the exception of 2000, was the largest generator of investment banking revenue over the past decade (Chart 20). Technology companies' share of fee revenue declined sharply from their 39% peak at the start of the decade to 13% in 2009. Fee income from the energy sector, particularly oil, gas and power companies, increased markedly over the past decade, having grown more than four-fold. Other fee generating industries include the consumer, healthcare and capital goods sectors.

Largest investment banks

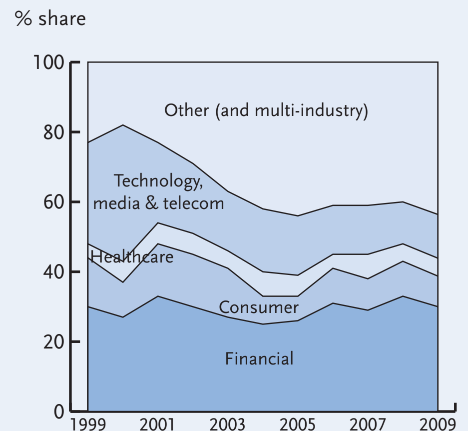
The credit crisis has had a profound effect on the investment banking industry. Several investment banks failed, were bailed-out by governments, or merged since the start of the downturn. While the specific circumstances varied, in general the decline in the value of mortgage-backed securities held by these companies resulted in either their insolvency or inability to secure

Chart 19 Global M&A activity



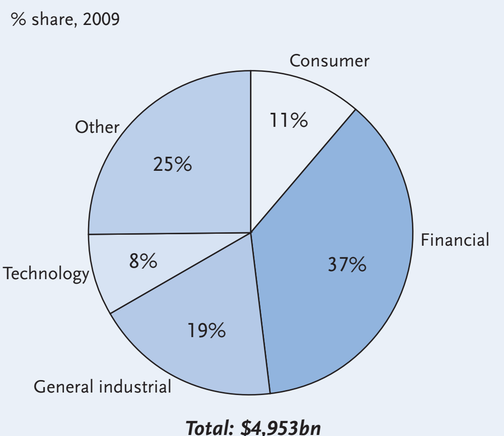
Source: Thomson Financial

Chart 20 Global investment banking sources of revenue by industry



Source: www.freeman-consultingservices.com

Chart 21 UK investment banking sources of revenue by industry



Source: www.freeman-consultingservices.com

new funding in the credit markets. The five largest US investment banks with combined debts of $4 trillion either went bankrupt (Lehman Brothers), were taken over by other companies (Bear Stearns and Merrill Lynch), or were bailed-out by the US Government (Goldman Sachs and Morgan Stanley) during 2008.

Consolidation in the investment banking sector has created a smaller number of global companies which dominate the industry (Table 5). Other investment banks have focused on particular products or regions. In 2009 the largest eight global investment banks generated more than a half of global investment banking revenue. Consolidation in Europe has created larger investment banks, although these are still not as big as their US counterparts, whose capital resources enable them to offer a broad product range supported by strong international distribution networks.

Table 5 Largest investment banks

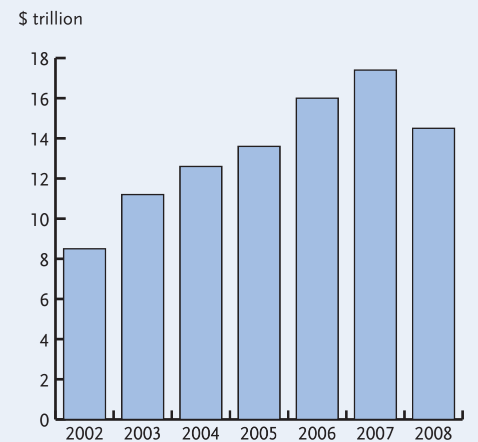
2009	Revenue $m	Debt %	Equity %	Loans %	M&A %	Annual change %
1 JP Morgan	5,455	29	45	6	20	7
2 Bank of America Merrill Lynch	4,057	31	41	9	19	n/a
3 Goldman Sachs	4,044	20	47	1	31	3
4 Morgan Stanley	3,578	23	49	1	27	21
5 Citi	3,394	34	37	6	23	9
6 Credit Suisse	3,029	32	43	2	23	7
7 Deutsche Bank	2,800	40	36	5	20	11
8 UBS	2,785	24	47	2	27	-13
9 Barclays Capital	2,026	53	21	7	19	-16
10 RBS	1,542	51	34	7	8	4

Source: Dealogic, FT.com

Private banking

Pre-tax profits of private banks fell by a third during 2008, while assets under management declined by 16% to $14.5 trillion (Chart 22). The fall in profitability was more pronounced in Europe which saw a 42% decline in profits and 15% decline in assets under management. The fall in assets under management was due to a combination of reduced net inflows of funds and negative performance. Private banks with the highest gross margins since the start of the credit crisis were those with strong deposit and lending capabilities. Regulatory changes in the wider banking industry may bring tighter scrutiny on private banking business, particularly offshore business which accounts for around a third of private banking business. Global and national rules aimed at preventing a recurrence of the recent financial crisis could also limit the range of services and products on offer.

Chart 22 Global private banking industry assets under management

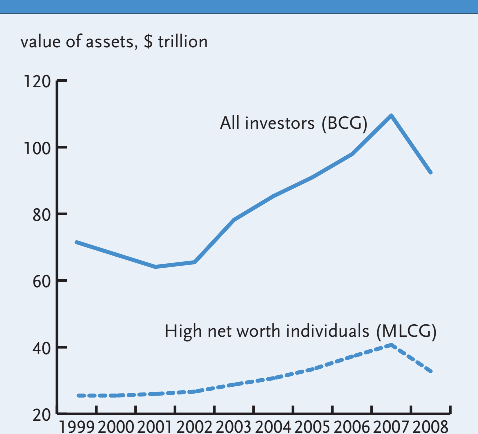


Source: Scorpio Partnership Ltd

Merrill Lynch/Cap Gemini Ernst & Young's (MLCG) annual *World Wealth Report* 2009 estimates that the value of funds managed on behalf of 8.6 million high net worth individuals (NWIs) with over $1m of investable assets was $32.8 trillion in 2008 (Chart 23). The economic turmoil, declines in equity markets and property markets all contributed to the fall. The effects were more pronounced in the US than the rest of the world. BCG, in its annual report *Global Wealth 2009*, estimated that the total value of assets managed on behalf of all investors fell by 12% in 2008 to $92.4 trillion. Merrill Lynch Capgemini expect the Asia-Pacific region to overtake North America as the largest concentration of wealthy people in the world by 2013. Private wealth growth in China and India should present unprecedented growth opportunities for the private banking industry.

Private banking in the UK London is one of the major onshore centres for private banking along with New York, Tokyo, Singapore and Hong Kong. A trend in recent years has been the gradual growing attraction of onshore centres. This trend is likely to continue with tightening of banking sector regulations. UK offshore locations are amongst the more important destinations for offshore banking.

Chart 23 Global private wealth



Source: The Boston Consulting Group (BCG)
Merrill Lynch Capgemini (MLCG)

Largest private banks The private banking market is relatively fragmented with many medium sized and small players. It is however heavily concentrated at the top end with the largest three private banks accounting for around a third of global assets under management at the end of 2008 (Table 6). Banks from Switzerland and the US feature high in the rankings. Bank of America had the most assets under management having overtaken UBS during the year following its merger with Merrill Lynch. UBS and Citi were the next largest banks. HSBC is the only UK bank to feature on this list, although all of the top private banks have a substantial presence in London.

Table 6 Largest private banks

Assets under management, end-2008

	$bn	% share
1 Bank of America	1,501	10.4
2 UBS	1,393	9.6
3 Citi	1,320	9.1
4 Wells Fargo	1,000	6.9
5 Credit Suisse	612	4.2
6 JP Morgan	552	3.8
7 Morgan Stanley	522	3.6
8 HSBC	352	2.4
9 Deutsche Bank	231	1.6
10 Goldman Sachs	215	1.5
Other	6,802	46.9
Total	14,500	100.0

Source: Scorpio Partnership

Islamic banking

The global market for Islamic financial services, as measured by sharia compliant assets, is estimated by IFSL to have reached $951bn at end-2008, 25% up from $758bn in 2007 and three quarters up on the 2006 total (Chart 24). Islamic commercial banks accounted for the bulk of the assets with investment banks and sukuk issues making up most of the remainder.

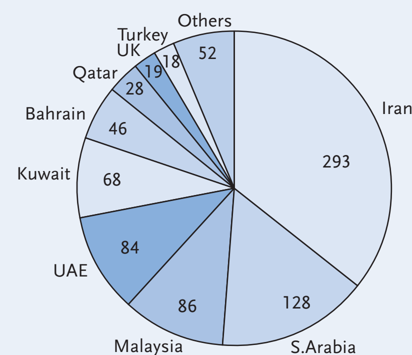
Islamic banks have been perceived favourably since the onset of the financial crisis in 2008 as they have been less exposed to losses from investment in toxic assets. However, they have not been immune from the effects of the crisis and the subsequent economic downturn. Some Islamic banks have suffered a higher rate of non-performing loans than conventional banks, mainly due to their exposure to falling real estate markets. Revenue and profitability has suffered in both 2008 and 2009 and liquidity is a significant restraint for some banks.

Key centres are concentrated in Malaysia and the Middle East including Iran, Saudi Arabia, Malaysia, Kuwait, UAE and Bahrain. The UK, in 8th place, is the leading Western country and Europe's premier centre with $19bn of reported assets, largely based on HSBC Amanah. Assets in other Western countries are currently small.

While London has been providing Islamic financial services for 30 years, it is only in recent years that this service has begun to receive greater profile. An important feature of the development of London and the UK as the key Western centre for Islamic finance has been supportive government policies intended to broaden the market for Islamic products. In the UK, five fully sharia compliant banks have been established putting it in the lead in Western Europe. In addition, there are an estimated 17 conventional banks that have set up windows in the UK to provide Islamic financial services.

Chart 24 Islamic finance

Banking, Takaful & fund assets, $bn, end-2008



Banking, Takaful & fund assets end-2008: $822bn

Source: The Banker

THE UK BANKING INDUSTRY

The UK banking sector is the leading centre for international banking and home to several of the largest global banks. Many UK banks were heavily impacted by the financial crisis through their exposure to sub-prime related securities and the subsequent deterioration of UK markets for credit and funding. In addition, the UK experienced a property price cycle similar to that seen in the US.

Liquidity in the UK's banking system was at its highest level in at least 17 years in April 2007 (Chart 25). Excessive leverage, or overly large balance sheets relative to shareholders' equity, and the rise of more complex financial products contributed to excessive risk taking by some banks. In the 5 years leading up to the credit crisis UK commercial and investment bank leverage increased from around 20 times to up to 30 times (Chart 26). As funding pressures increased and liquidity on wholesale markets dropped banks became reluctant to commit funding to interbank markets.

Various measures by the UK Government and Bank of England to boost lending helped to increase activity on the interbank markets. Market loans of UK resident banks totalled over £230bn during 2009 following a negative outflow of £10bn in the previous year. Similarly, claims under sale and repurchase agreements increased by £75bn in 2009 following a £63bn reduction in 2008 (Chart 27). UK banks raised more than £50bn through capital markets in the second half of 2009, taking the total raised from the start of the credit crisis to nearly £130bn.

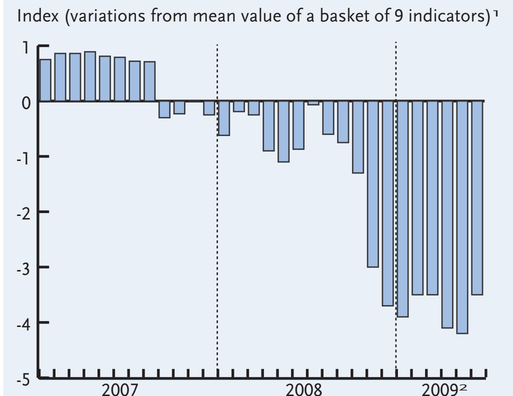
As concerns about solvency eased and the wider equity market recovered, UK banks' equity prices rose by 40% between March 2009 and the end of the year, recovering a big part of the losses of the previous nine months. Although the situation has improved, significant challenges remain for the banking system, and over the next five years UK banks will need to refinance over £1 trillion of wholesale funding, including funding that has been supported by the public sector. Liquidity remains strained although the financial system has been significantly more stable in the latter part of 2009.

Assets of the UK banking sector totalled £7,616bn at the end of 2009, down 4% on the previous year's record total (Chart 28). Foreign banks held 51% of total assets. Over the past decade there has been a growing presence of banks from the EU, which gradually increased their share of foreign banks' assets from 49% to 54%. US banks' share fluctuated between 13% and 16% while the share Japanese banks' assets declined from 9% to 5% (Chart 29).

Number of banks The UK banking sector consists of banks incorporated in the UK and foreign banks operating in the UK.

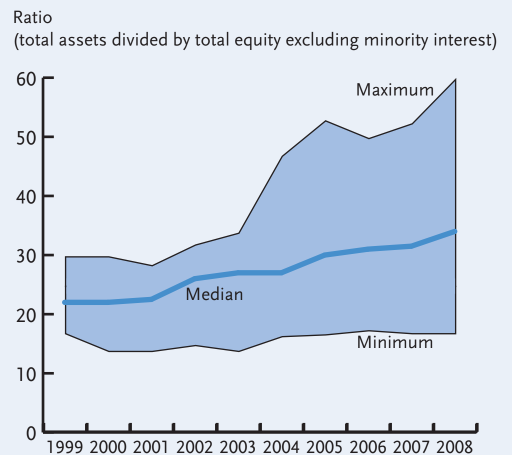
UK incorporated banks The number of UK incorporated banks declined between 1999 and 2007 from 200 to 159 due to a fall in the number of UK-owned banks (Table 7). This was mostly due to mergers and closures of some small institutions. UK incorporated banks consist of UK and foreign owned banks authorised by the Financial Services Authority (FSA) under the

Chart 25 Index of UK financial market liquidity



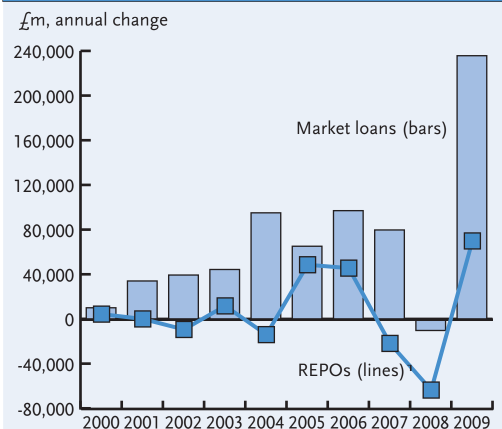
¹ indicators include gaps between bid-and-offer prices on bonds, currencies and stocks, the ratio of returns to trading volumes, and spreads in the credit market; ² January to June
Source: Bank of England, Bloomberg

Chart 26 UK banks' leverage



Source: Bank of England, IFSL calculations

Chart 27 UK resident banks' interbank lending



¹ Claims under sale and repurchase agreements
Source: Bank of England

UK banking sector interventions

The UK Government has used various instruments to support the banking system through the credit crisis. To address concerns about liquidity, the Bank of England made more than £200bn available to banks under its Special Liquidity Scheme (SLS). The SLS, which was introduced in April 2008, provided banks and building societies with access to short-term liquidity by allowing them to temporarily swap pre-existing, illiquid financial assets for highly liquid Treasury bills.

Other measures in 2008 included the nationalisation of Northern Rock, part nationalisation part sell-off of Bradford & Bingley, brokering the Lloyd's TSB/HBOS merger and recapitalisation and guarantees for the enlarged Lloyd's Banking Group (up to 65% stake) and the Royal Bank of Scotland (70% stake). UK Financial Investments Limited was set up in November 2008 to manage the UK Government's investments in financial institutions including the Royal Bank of Scotland, Lloyd's Banking Group, Northern Rock and Bradford & Bingley.

In January 2009 the UK Government announced a further package of measures to support the banking sector. Amongst various measures, the Government introduced the Asset Protection Scheme which provided banks with protection for a proportion of their balance sheets so that the healthier core of their commercial business could continue to lend. In return for access to the Scheme, banks were required to pay a fee and enter into legally binding agreements to increase the amount of lending they provide to homeowners and businesses. Various other measures were introduced by the Government in 2009 to stimulate lending.

In March 2009, the Bank of England announced that, in addition to reducing the rate to 0.5%, it would start to inject money directly into the economy. Through its quantitative easing programme, the Bank of England injected £200bn into the economy in 2009 by purchasing assets such as government and corporate bonds from commercial banks and other financial businesses.

In November 2009 the Financial Services Bill was introduced into Parliament. The Bill builds on the action taken so far by the Government in response to the financial crisis, and delivers wide-reaching reforms to strengthen financial regulation, support better corporate governance and provide protection to consumers. The Bill calls for a new Council for Financial Stability which is intended to consist of Treasury, Bank of England and FSA officials. It also requires major banks to hold larger capital reserves and to prepare so-called "living wills" to ensure they could be wound up in the case of failure.

Financial Services and Markets Act 2000 (FSMA). These mainly include commercial banks, investment banks, foreign owned banks and banks operated by retail companies.

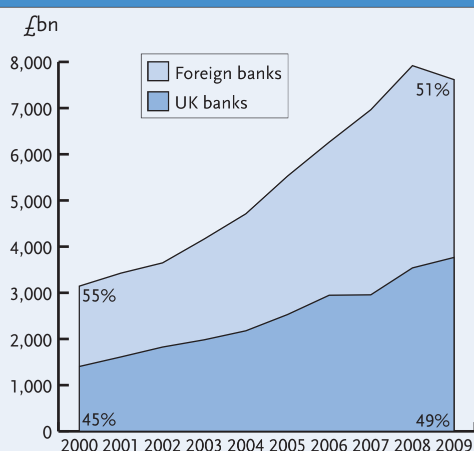
Foreign banks in the UK London is a major centre for international banking and many foreign banks have located branches and representative offices there. In March 2007 there were 249 foreign banks that were physically located in the UK, with the majority of these located in the City of London. Most of these banks were from Japan, Germany, US, Italy and Switzerland. There are also more than 200 banks from the European Economic Area

Banks' assets and liabilities

Over a half of banks assets are held in lending. Banks' other assets consist of a small amount of cash to meet normal deposit withdrawals; short term or easily realisable bills (both Treasury and commercial), investments, claims under sale and repurchase agreements.

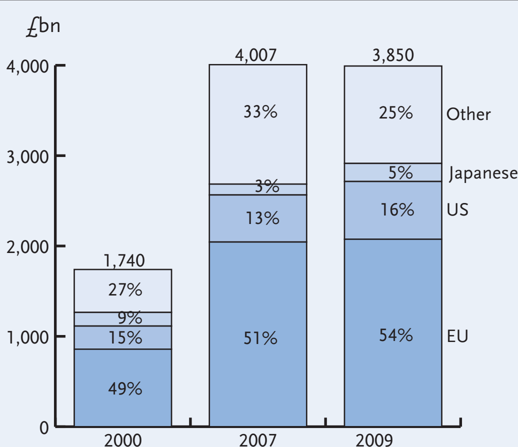
Around 90% of banks' liabilities consist of sight and time deposits. Around a fifth of deposits are held in repos, certificates of deposit, short-term paper and acceptances. The remaining liabilities are primariliy made up of non-deposit funds such as shareholder capital and accumulated reserves.

Chart 28 UK banking sector assets



Source: Bank of England, IFSL calculations

Chart 29 Foreign owned UK banking sector assets by country



Source: Bank of England, IFSL calculations

Table 7 Number of banks in the UK

End- March	1995	1999	2008	2009
Incorporated in the UK	224	200	156	159
UK owned	142	121	70	71
Foreign owned [1]	82	79	86	88
Incorporated outside the UK	257	244	168	166
UK branch of an EEA firm [2]	102	109	84	82
UK service of an EEA firm[1]	---	---	4	5
Outside the EEA [3]	155	135	80	79
Total authorised banks	**481**	**444**	**324**	**325**
Foreign banks physically located in the UK [1]+[2]+[3]	339	323	250	249
Channel Islands & Isle of Man[2]	41	-	-	-

[1] Figures for 'UK service of an EEA firm' only available from 2005
[2] From Sep-1997 Channel Islands and Isle of Man institutions were no longer considered part of the UK banking sector
Source: Bank of England, Financial Services Authority

operating in the UK without an actual physical presence in the UK. This has been facilitated by the Banking Consolidation Directive regulations which provide for home country supervision of branches of EEA incorporated banks throughout the EEA.

Lending Bank lending can be subdivided into advances, which account for around two-thirds of sterling lending, and market loans which account for most of overseas lending. Due to the substantial presence of foreign banks in the UK, around a third of UK bank lending is targeted towards overseas customers although this proportion has declined over the past two years as foreign banks repatriated funds as liquidity fell. The outstanding value of lending totalled £4,933bn at the end of 2009, down 6% on the previous year.

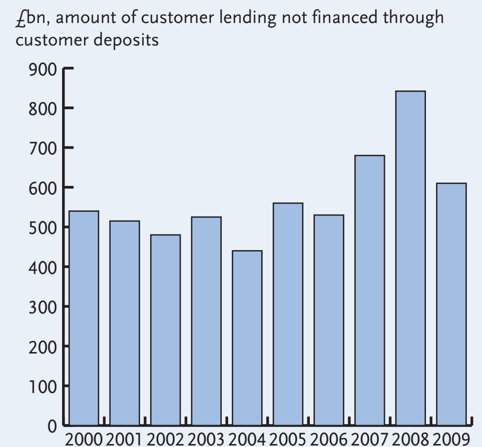
In the years leading up to the credit crisis, major banks developed a growing reliance on wholesale money market funding in preference to traditional deposits from customers (Chart 30). In 2008 40% of customer loans or over £800bn was funded through wholesale money markets, much of this from overseas. This has declined in 2009 to around £600bn.

Personal lending More than a half of UK bank lending is targeted towards domestic customers. Over the past decade there has been a significant movement away from manufacturing and wholesale and retail trade towards personal lending, particularly mortgage lending. The outstanding value of mortgage lending totalled £871bn at the end of 2009 or 34% of total domestic lending. The value of mortgage lending remained close to record levels in 2008 and 2009 despite reduced activity on wholesale bond markets, a major source of mortgage funding for some banks in recent years. There has however been a decline in the annual value of net lending for mortgage finance in 2008 and 2009 (Chart 33). A monthly trend analysis for 2009 shows a gradual improvement during the year. Around 185,000 first-time buyers entered the market in 2009, 4% fewer than in 2008 and just over a third of the 532,000 in 2002. Difficulties in meeting repayments ment that annual mortgage repossessions totalled 55,000 in 2009, up 10% on the previous year but more than double the number in 2007.

Corporate lending has doubled over the past decade. This was paralleled by a changing pattern in bank lending to companies both in the direction and maturity of lending. Financial services increased its share of bank lending mostly at the expense of manufacturing and wholesale and retail trade while the maturity of lending has shortened in recent years. Foreign-owned banks account for over a third of lending to the corporate sector.

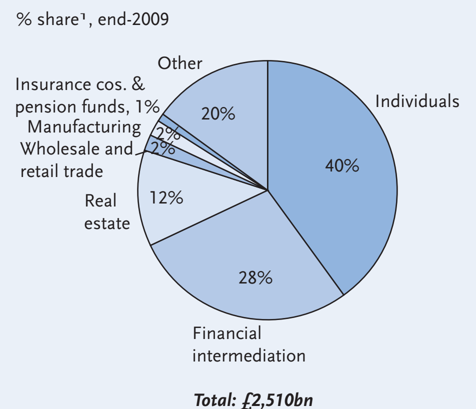
Overseas business Around a third of UK bank lending is targeted towards overseas customers. This is largely due to the substantial presence of foreign banks in the UK and London's role as a major international financial centre. External business of banks operating in the UK fell sharply since the start of the economic crisis (Chart 32). Amounts outstanding totalled $6,041bn at the end of Q3-2009, down from a peak of nearly $8,000bn in Q1-2008. The largest borrowers from banks in the UK were customers in the US with 17% of the total, followed by those in Germany with 8% and the Netherlands 6%.

Chart 30 Major UK banks customer funding gap



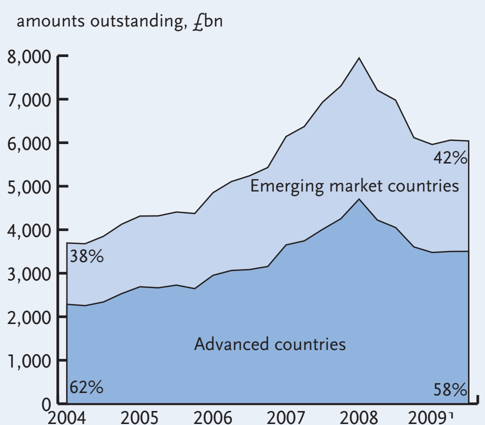
Source: Bank of England, IFSL calculations

Chart 31 Industrial breakdown of lending to UK residents



¹ Not seasonally adjusted
Source: Bank of England, IFSL calculations

Chart 32 External business of banks operating in the UK



¹ up to Q3-2009
Source: Bank of England, IFSL calculations

Deposits The outstanding value of deposits in UK banks totalled £6,910bn at the end of 2009. This was down 5% on the previous year as foreign currency deposits fell.

Domestic banks accounted for 43% of total UK deposits in 2009. The dependence of UK banks on domestic retail and corporate customers means that the majority of their funds are in sterling. Nevertheless, around 40% of domestic banks' assets were held in foreign currency at the end of 2009 (Chart 35). This is because a large proportion of funds are handled on behalf of foreign customers through the wholesale markets.

The main source of banks' domestic deposits are personal savings. An analysis of UK residents' deposits shows that personal customers accounted for 40% of the UK residents total. The banks themselves deposit surplus funds with other banks and accounted for 31% of the total. Real estate companies, insurance companies, pension funds and manufacturing companies generated most of the remainder. Other deposits, which cannot by their nature be attributed to individual sectors, consisted of certificates of deposit, other short-term paper and acceptances.

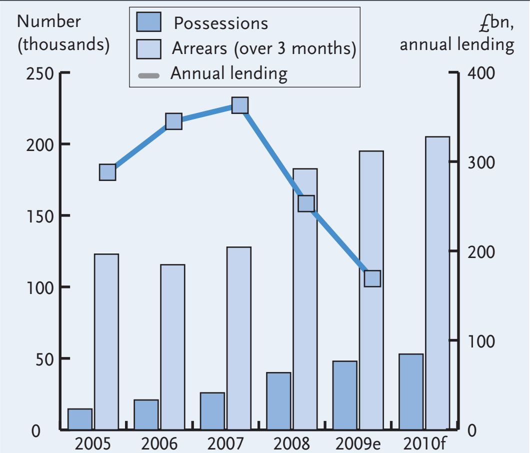
Overseas banks located in the UK accounted for more than a half of total UK deposits in 2009. Most of these funds (52%) were deposited with banks in EU countries (mostly Germany, Switzerland and Netherlands). US banks held 17% of the total and Japanese 5%. Since overseas banks are predominantly serving an overseas customer base only a quarter of their deposits were held in sterling. The composition of foreign currency held by foreign banks in the UK has changed somewhat over the past decade as deposits held in euros increased their share of the total from 23% to 32% of total foreign currency deposits (Chart 35).

Income Although no collective data on profits are published for the banking industry as a whole, aggregated data for the Major British Banks' Group (MBBG) provides a good indication of overall trends. Financial results of the MBBG for 2008 show a net loss after operating expenses, of £7.9bn. This was largely a result of the slowdown of the global economy and write-offs during the year. In the decade prior to this, net income had risen consistently each year to a record £42.5bn in 2007 (Chart 36). Some banks reported a returns to profits in the first half of 2009 while others announcing further large write-offs. Barclays Bank for example reported pre-tax profits of £2.98bn in the first six months of the year, up 8% on the first six months of 2008. Lloyd's Banking Group on the other hand reported a £4bn loss following significant write-downs during this period.

Competitive pressures have reduced net interest margins in most banks over the past decade. This is a result of new players entering the market, including non-financial services companies such as retailers and motoring organisations, and overseas firms. In the decade up to 2008, average net interest margins declined from 2.2% to 0.8% (Chart 37).

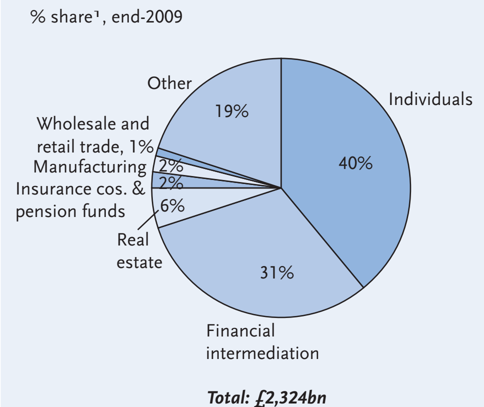
Competition has resulted in considerable pressure on operating expenses which fell from 2.0% of total assets to 1.4% during this period. Cost reduction has been an important factor in making UK banks, which are

Chart 33 Mortgage possessions and arrears



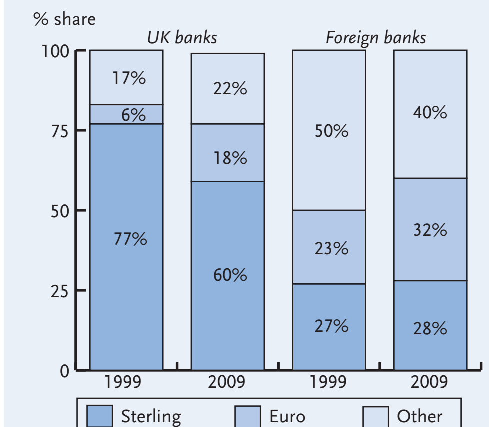
Source: Council of Mortgage Lenders; IFSL estimates

Chart 34 Industrial breakdown of deposits from UK residents



¹ Not seasonally adjusted
Source: Bank of England, IFSL calculations

Chart 35 Deposits of UK/foreign banks breakdown by currency



Source: Bank of England, IFSL calculations

Building societies are mutual organisations owned by their members and therefore have no external shareholders. Their main business activity is mortgage finance. At end-2009, there were 52 building societies, down from 80 a decade earlier. The gradual decline was largely due to mergers although a number of the larger building societies converted to plc status. In recent years, building societies have accounted for around a fifth of the outstanding value of personal deposits and mortgages and around 15% of net mortgage lending.

among the most efficient in Europe, competitive internationally. UK banks benefit from a flexible labour market, technology investment, outsourcing and offshoring.

Largest UK banks The total number of UK incorporated banks has been on a downward trend since the mid-1990s (Table 7) despite the conversion of a number of building societies into banks and increase in the number of new entrants into the market. The largest banks are the major high-street banks (Table 8), namely Royal Bank of Scotland HSBC Holdings, Barclays Bank and Lloyd's Banking Group. These banks dominate the UK current account market and account for over half of credit cards and personal loans.

In February 2008 Northern Rock was taken into UK Government ownership. In the eight years leading to the credit crisis, the bank had relied on a growth strategy which had largely been dependent on wholesale credit markets in funding its mortgage lending, with three-quarters of its funds coming from this source. Once the wholesale markets collapsed the bank was no longer able to fund its mortgages. Towards the end of 2008, the UK Government transferred Bradford & Bingley's retail deposit business along

Payments and settlements system

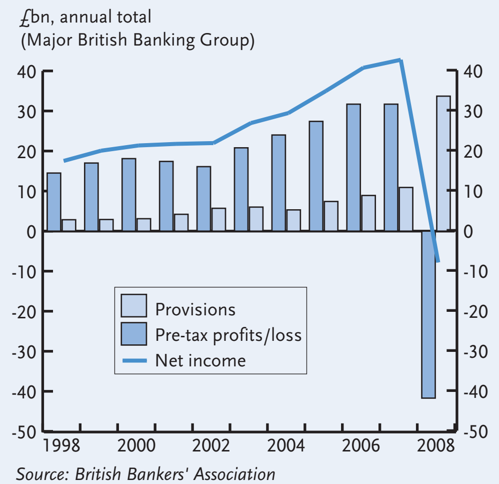
The majority of transactions are still made in cash although the proportion is falling steadily. The share of transaction volumes in cash fell from nearly a half to around a third of the total in the decade up to 2008. Technology has become increasingly important for the remaining transactions which include cheques, automated payments and plastic cards.

The clearing process involves the transmission and settlement of payments between accounts held at different banks or different branches of the same bank. Payment systems can broadly be divided into clearing networks and plastic card networks. Clearing networks in the UK include: Bankers Automated Clearing Services (BACS) for direct debits, direct credits and standing orders; real time gross settlement which is cleared by the Clearing House Automated Payments Scheme (CHAPS) and the Cheque and Credit Clearing Company (CCCL). Plastic card networks cover debit, credit and ATM cards.

The value of cleared payments fell by a third in 2008 to £88 trillion, a level not seen since the start of the decade. The fall in interbank lending was the main cause of the decline. Automated payments accounted for over three-quarters of the volume of transactions, up from around a half a decade earlier. However, such payments accounted for 99% of the value of transactions, up from 95% during this period (Chart 40).

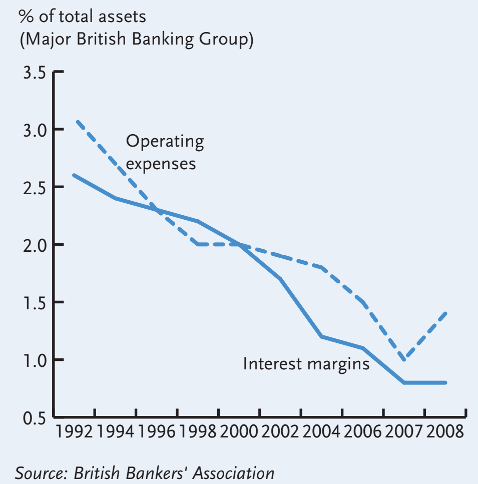
The number of cards in issue by banks totalled over 160m at the end of 2008 (Chart 41). Debit cards have become increasingly popular since their launch in 1987, reaching 76m in 2008. Both the number of debit card users and the number of payments made with each card are expected to grow. The number of credit cards in issue declined in the early 1990s following the introduction of fees and increased use of debit cards, but grew subsequently to 66m in 2008. It is difficult to draw conclusions regarding the number of other cards in issue because of their dual functionality with, for example, many debit cards functioning also in ATMs and for cheque guarantee.

Chart 36 Net income



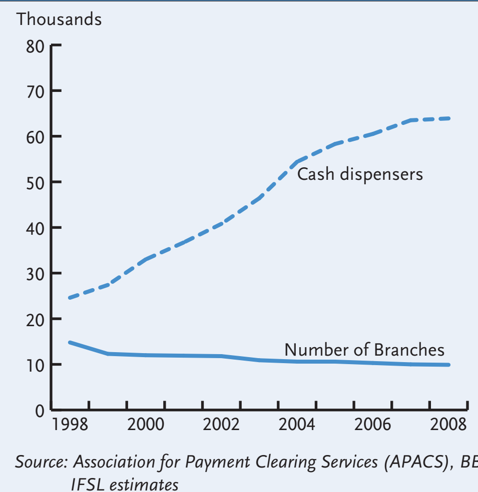
Source: British Bankers' Association

Chart 37 Interest margins and operating expenses of UK banks



Source: British Bankers' Association

Chart 38 Branches and cash dispensers in the UK



Source: Association for Payment Clearing Services (APACS), BBA IFSL estimates

Electronic delivery channels include ATMs, internet banking, corporate electronic banking, interactive TV and mobile telephone banking.

ATMs Parallel with the reduction of the branch network, there has been a steady increase in the importance of the ATM network. In the six years up to end-2008 the ATM network increased from 46,000 to over 60,000 (Chart 41). Around a third of ATMs are located in branches, a third in retail outlets, with social and leisure facilities accounting for most of the remaining locations. The extension of the ATM network has helped to fill the gaps created by the closure of some branches.

Internet banking On-line banking is growing in popularity as a delivery channel. It is becoming increasingly accessible to the wider market, cheaper and easier to use. The internet provides many advantages such as: removing the need for physical presence in new territories thus eliminating the need for in-country set-up and ongoing infrastructure costs; faster implementation of new products; reduction in marketing costs; and more efficient processing of transactions. This reduces transaction costs and lessens the importance of location. The UK is the largest market for online banking in Europe. Over 70% of UK households had home internet access at the end of 2009. Online banking usage in the UK increased from 12% of households in 2003 to 30% in 2009, a proportion which is set to increase in the coming years. The move online is likely to be accompanied by a change in the role of the remaining bank branches where large regional centres that offer financial planning may replace the traditional branch networks.

Corporate Electronic Banking is similar to internet banking but is more demanding, requiring greater security, involving a heavier volume of transactions and the ability to support multiple users at a single customer site.

Telephone banking remains a key area of service delivery for banks. It includes call centres, call routing, telesales and interactive voice response. Telephone banking can either be used to supplement one of the other channels or as a stand alone, primary delivery channel. Banks in the UK offer telephone banking services primarily to complement their existing activities and this has proven to be a very popular means of service delivery. Even stand-alone internet banks have provided telephone support as it was found that customers preferred telephones as a support channel to the internet.

with its branch network to Abbey National plc whilst the remainder of Bradford & Bingley assets was taken into public ownership with the intention of winding down operations. Also in late 2008, following a string of losses, HBOS, the UK's biggest mortgage lender at the time, and Lloyds TSB merged to become Lloyds Banking Group. The consolidated company accounts for nearly 30% of mortgage loans in the UK.

Branch networks remain an important point of service delivery for banks. Technology is having a major impact on banking in creating new ways in which banks are delivering services to their customers. The competitive pressures on banks' margins have kept the focus on cost control as a strategic priority. This has resulted in the reduction of the branch network. Many banks are seeking to reduce costs through a combination of outsourcing and offshoring.

Operations have in some cases been centralised, allowing lower unit processing costs. Staff numbers have been reduced in some branches and the profile of the work carried out by branch staff has been more oriented towards sales. During the past decade the number of branches in the UK fell by over a quarter, to below 10,000 (Chart 38). The closure in the number of branches is likely to accelerate in the coming period due to a number of large mergers over the past two years and a further drive towards cost containment.

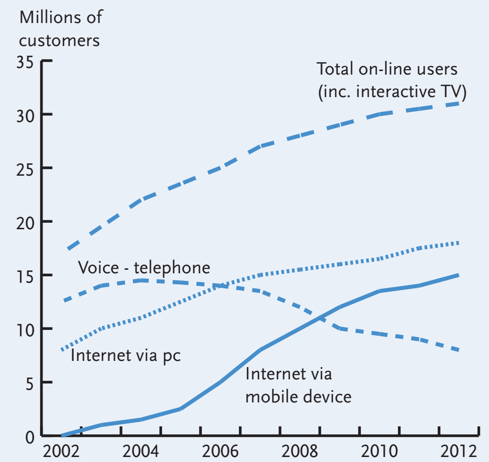
Table 8 Largest UK banks

$bn, end-2008	Tier one capital	Assets
1 Royal Bank of Scotland	101.8	3,501
2 HSBC Holdings	95.3	2,418
3 Barclays Bank	54.3	2,993
4 HBOS[4]	28.8	1,006
5 Lloyds TSB Group	20.0	636
6 Standard Chartered	19.0	435
7 Abbey	7.9	338
8 Clydesdale Bank[1]	4.1	84
9 FCE Bank Plc	4.0	32
10 Alliance & Leicester	2.7	110
11 Bradford & Bingley	2.6	82
12 Schroders	2.4	11
13 Standard Bank	1.4	35
14 The Co-operative Bank[2]	1.2	22
15 Close Brothers Group[3]	1.1	12

[1] 9/2008; [2] 1/2009; [3] 7/2008; [4] merged with Lloyd's TSB to create Lloyd's Banking Group

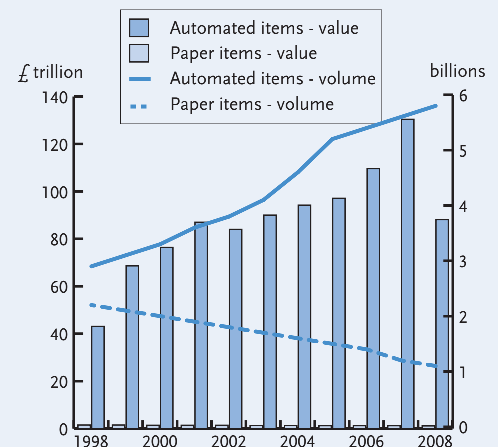
Source: The Banker

Chart 39 On-line distribution channels in the UK



Source: APACS

Chart 40 Value and volume of cleared payments in the UK



Source: APACS

The Post Office role as a banking distribution channel has been expanding given that it is the largest cash handler in the UK. A number of banks have established partnerships with the Post Office, which allow their customers to use these offices for their basic banking needs.

CONTRIBUTION TO THE UK ECONOMY

The UK banking sector is a crucial and integral part of the UK economy. Its core business of taking deposits from one set of customers and lending to a largely different set provides an essential market mechanism for distributing funds to where they are most required and providing a return to those wishing to hold assets in liquid form. A modern economy could not operate without this mechanism, but its "value" is difficult to measure statistically. This section analyses the more quantifiable contributions of banking to national output, profitability, employment and net exports.

Output

According to the Office for National Statistics, the banking industry contributed around £58bn to UK national output in 2007. This was equivalent to 4.7% of Gross Domestic Product (GDP), or over half of the 8.3% accounted for by the financial sector as a whole.

In the decade up to 2007, the banking sector grew in current prices at an average of around 4.0% a year (Chart 42). This was slower than the increase in GDP (4.2%) partly due to a greater advance in the efficiency of banking compared to some other sectors which had an adverse affect on its contribution to GDP. Activity in the banking sector has been more volatile than other sectors over the past decade, mainly due to the sensitivity of banking profits to the business cycle. The banking sector showed strong growth in recent years due to the recovery of the global economy and capital markets.

Employment

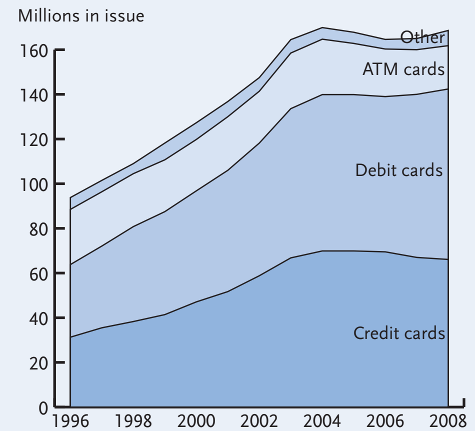
According to the BBA (British Bankers' Association), the UK banking industry provided employment for 435,000 (Table 9) people at the end of 2008. This represented around 1.5% of total UK employment or around 45% of financial services employment. During the past decade, banks have made considerable efforts to reduce costs including staffing which typically accounts for over half of operating expenses.

A detailed breakdown of employment statistics in 2008 shows that retail banks accounted for nearly 80% UK banking sector employment. Foreign subsidiaries and branches accounted for a further 30,700, global banks for 37,100, investment banks for 8,700 and other domestic banks for 24,500.

Net exports and investment

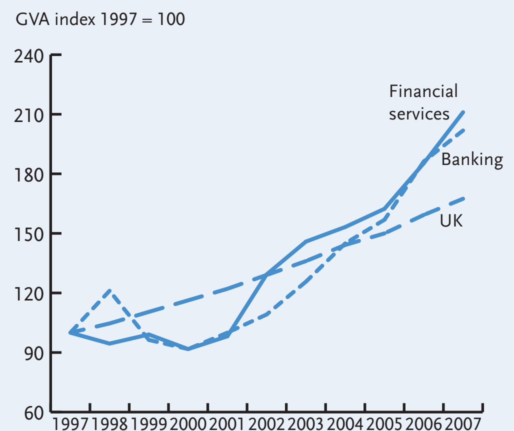
Banks were the much largest contributor in 2008, with net exports totalling £31.1bn (Chart 43). The contribution to banks' net exports comes from four

Chart 41 Plastic cards



Source: APACS

Chart 42 UK output



Source: Office for National Statistics

Table 9 UK banking sector employment

Thousands	Major British Banking Group[1]	Other British Banks	TOTAL
2003	327	141	443
2004	330	128	437
2005	326	116	440
2006	317	106	432
2007	315	110	436
2008	312	111	435

[1] MBBG includes The Abbey National, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC Bank, Lloyd's TSB, Northern Rock, The Royal Bank of Scotland and National Westminster

Source: British Bankers' Association

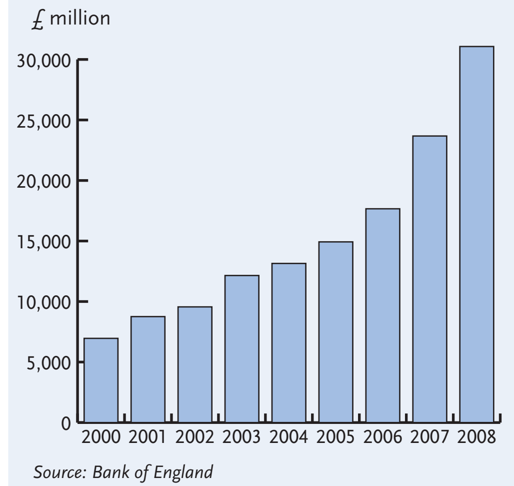
sources: spread earnings; FISIM; net fee income from financial services; and other net exports (also fee income) from non-financial services.

Spread earnings and FISIM exports combined made up 85% of banks' net exports in 2008. Spread earnings of £11.1bn from securities, derivatives and foreign exchange transactions were up from £9.5bn in 2007. Derivatives are estimated to account for the lion's share of these spread earnings. FISIM exports also rose by 81% from £8.5bn to £15.4bn, as a result of increasing margin on loan and deposit rates.

Total net fee income of banks on financial transactions fell just over a quarter to £3.1bn in 2008 from £4.3bn in 2007. Most categories of fee income were down in 2008 including new issues of securities and portfolio and securities transactions both of which roughly halved, respectively, to £294m and £740m. Commitment fees and credit and bill transactions each dropped by 15% to £1.2bn and £282m respectively. Derivatives fees were virtually unchanged at £225m: the bulk of derivatives earnings are generated on the spread. Residual fee income from financial services was £397m. Other non-financial net exports of banks were stable at £1.4bn in 2007.

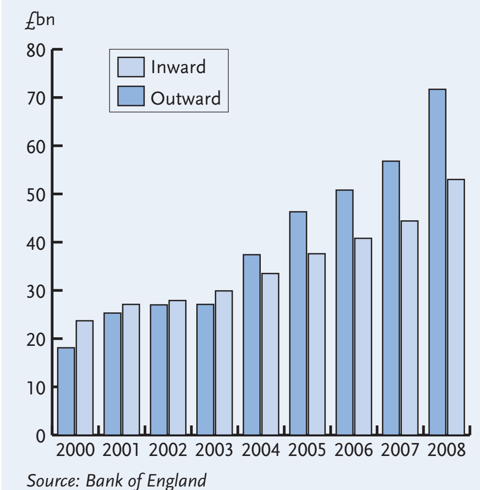
Foreign direct investment Latest available figures show that inward investment or investment into the UK banking sector more than doubled over the past decade to reach £53.0 billion (Chart 44). During this period outward investment grew more than five-fold to £71.7bn.

Chart 43 UK banks' net exports



Source: Bank of England

Chart 44 Banks' foreign direct investment



Source: Bank of England

LINKS TO OTHER SOURCES OF INFORMATION

APACS
Yearbook of Payment Statistics
www.apacs.org.uk

Bank for International Settlements
International Banking and Financial Market Developments (Quarterly)
www.bis.org

Bank of England
Financial Stability Report
Monetary and Financial Statistics
www.bankofengland.co.uk

British Bankers' Association
Annual Abstract
www.bba.org.uk

European Banking Federation
www.fbe.be

Financial Services Authority
www.fsa.gov.uk

Freeman & Co
Investment banking statistics
www.freeman-consultingservices.com

Merrill Lynch / Capgemini
World Wealth Report
www.ml.com

Office for National Statistics
UK National Accounts - Blue Book
UK Balance of Payments - Pink Book
www.statistics.gov.uk

The Banker
Top 1000 World Banks - July edition
www.thebanker.com

The Boston Consulting Group
www.bcg.com

UK Financial Investments Limited
www.ukfi.gov.uk

IFSL Research:

Report author: Marko Maslakovic

Director of Economics: Duncan McKenzie
d.mckenzie@ifsl.org.uk +44 (0)20 7213 9124

Senior Economist: Marko Maslakovic
m.maslakovic@ifsl.org.uk +44 (0)20 7213 9123

International Financial Services London
29-30 Cornhill, London, EC3V 3NF
www.ifsl.org.uk

International Financial Services London (IFSL) is a private sector organisation, with nearly 40 years experience of successfully promoting the exports and expertise of UK-based financial services industry throughout the world.

This report on Banking is one of 16 financial sector reports in IFSL's City Business Series. All IFSL's reports can be downloaded at *www.ifsl.org.uk*.

© Copyright February 2010, IFSL

Data files

Datafiles in Excel format for all charts and tables published in this report can be downloaded from the Reports section of IFSL's website **www.ifsl.org.uk**

Sign up for new reports

If you would like to receive immediate notification by email of new IFSL reports on the day of release please send your email address to **download@ifsl.org.uk**

In partnership with:

International Financial Services, London is a private sector organisation, with nearly 40 years experience of promoting the UK-based financial services industry throughout the world.

City of London Corporation administers and promotes the world's leading international finance and business centre and provides free inward investment services.

UK Trade & Investment helps UK-based companies succeed in international markets and assists overseas companies to bring high quality investment to the UK's vibrant economy.

This brief is based upon material in IFSL's possession or supplied to us, which we believe to be reliable. Whilst every effort has been made to ensure its accuracy, we cannot offer any guarantee that factual errors may not have occurred. Neither International Financial Services, London nor any officer or employee thereof accepts any liability or responsibility for any direct or indirect damage, consequential or other loss suffered by reason of inaccuracy or incorrectness. This publication is provided to you for information purposes and is not intended as an offer or solicitation for the purchase or sale of any financial instrument, or as the provision of financial advice. Copyright protection exists in this publication and it may not be reproduced or published in another format by any person, for any purpose. Please cite source when quoting. All rights are reserved.