Chandrawat & Partners

GLOBAL PERSPECTIVE OF BANKING AND FINANCIAL SECTOR

enquiries@chandrawatpartners.com| www.chandrawatpartners.com

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INTRODUCTION

Banking and financial institutions play a crucial role in the functioning of economies, facilitating economic growth, capital allocation, and financial intermediation. With the increasing interconnectedness of global markets and the evolving regulatory landscape, it has become essential to have a broader perspective on the sector, its challenges, and the opportunities it presents.

Over the last two decades there has been a significant effort made to quantify the amount of international banking and financial services provided and improve and enhance the way these international data are entered into national statistics. A number of research studies explored the role of financial development, an effective financial services sector and deregulation of financial markets as those factors that have contributed to economic growth and to global financial market integration.

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There are multi-fold changes that have occurred in the banking sector as a result of the system shocks brought about by geopolitical instability and the ongoing disruptive effects of the COVID-19 pandemic. The findings are not optimistic: although revenue and margins increased due to higher interest rates, more than half of the world's banks are trading below their book value. In fact, banking ranks at the bottom when comparing the market valuations of different industry sectors, primarily due to its weak profit margins and low growth expectations.

The well-known saying, 'there are decades when nothing happens, and weeks when decades happen,' has been attributed to various sources, none of whom are known for their expertise in banking. However, for the global banking industry, this statement accurately captures the events that unfolded in 2022. After a decade of relative stability and predictability, the landscape suddenly shifted as inflation surged, interest rates skyrocketed, and markets, including stocks, bonds, cryptocurrencies, and Chinese real estate, experienced heightened volatility.

The main takeaway is that banks worldwide must work harder to "future-proof" themselves in light of growing divergence and relatively better returns in 2022. They must enhance their short-term resilience and embrace longer-term opportunities to expand and increase their profits.

ECONOMIC OVERVIEW

The global banking industry has been unusually flat over the past 12 years. The return on equity hovered around the cost of equity or less. Due to low interest rates, increased competition, notably from well-funded big IT companies, and revenue growth that was still below GDP growth, margins were slowly eroded. Emerging markets with their strong economic performance closed the gap with advanced economies; China featured as a consistent outperformer. Low-interest rates encouraged an upward trend in asset values that seemed inexorable, and some high-risk asset classes, such as cryptocurrencies, experienced significant gains.

After a decade or more of contraction, interest rates surged from their historic lows, and along with them, bank profitability increased. Banks' return on equity eventually exceeded the cost of capital on a global scale after years of declining below it. The scenario under which bank operates changed rapidly. The context that banks work in has also altered. While the COVID-19 pandemic's longer-term effects continued to ripple through the world economy, the Russian invasion of Ukraine and increased conflict over Taiwan forced geopolitics onto business agenda worldwide. Sustainable finance moved from being an emerging and imprecise theme to a better-defined source of growth.

On a country-by-country basis, China, which had previously been the driving force behind global growth in the banking and other sectors, had the weakest banking performance due to pandemic lockdown and its troubled overleveraged real estate market. Several factors contribute to the relatively low valuations observed across the banking sector such as relatively low profit margins due to intense competition, regulatory cost and low interest rate, economic uncertainty, regulatory requirements and rise of digital technology with increase popularity of fintech companies. Only approximately 15% of financial organisations are profitable and expanding quickly, despite the fact that roughly half of banks make positive economic profits.

MARKET DYNAMICS

The worldwide market dynamics of the banking and financial sector are complex and constantly evolving. Several factors contribute to shaping the landscape of this sector on a global scale.

Bank Leverage: A bank's leverage decision, where leverage is defined as the ratio of bank assets to bank net worth has implications for growth and solvency. On the one hand, leverage increases the potential for a higher return on net worth. On the other hand, leverage increases the variance in returns on net worth and the probability of bank failure risk, where failure is defined as the event where a bank's net-worth drops below zero. In this sense, bank leverage decisions have implications for banking industry dynamics that include entry, exit and size distribution and for such macroeconomic aggregates as output, investment, and distribution of consumption.

In the presence of a friction between bank ownership and management, bank leverage decisions can be socially inefficient, and the heterogeneity of bank size and bank productivity matters for the size of this inefficiency. For example, high leverage by a large bank can lead to greater variance in the return on net-worth compared with the same high leverage by two or more smaller banks obtained by splitting up the large bank, this is because, in the case of small banks, there is some diversification of shock across banks, whereas the case of the large bank would correspond to that of perfectly correlated shocks.

Financial interconnectedness: Countries are financially interconnected through the asset and liability management ("ALM") strategies of their sovereigns, financial institutions, and corporations. In particular, the speed with which illiquidity and losses in some markets can translate into global asset re-composition points to interconnectedness risks. The vast majority of global finance is intermediated by a handful of large, complex financial institutions ("LCFIs"), which transact on a few payments and settlements systems and operate out of a small set of countries that serve as global common lenders and borrowers.

The countries form the core of cross-border financial flows and connect countries. The transmission of shocks and the spill over of policies and financial conditions occur largely through these core economies. This globalization has led to greater interconnectedness and interdependence among financial markets worldwide. Developments in one region can have significant ripple effects on other markets.

Geopolitical factors: Geopolitical events and policies have the potential to disrupt the global banking and financial sector. Trade tensions, political instability, economic sanctions, and changes in government policies can significantly impact international banking operations, capital flows, and investor confidence. Geopolitical risks introduce uncertainties and require financial institutions to assess and manage their exposure to potential disruptions.

Imposing financial restrictions, or increased uncertainty and risk aversion generated by geopolitical tensions, could exacerbate global financial fragmentation as international investors reallocate investment portfolios and credit lines away from geopolitically more distant countries. This could trigger a sharp reversal of capital flows and a decline in asset prices, with associated consequences for macro-financial stability.

Regulatory challenges and complexity: Regulatory challenges and complexity in the banking and financial sector refer to the difficulties faced by regulators in developing and implementing effective frameworks that balance stability, consumer protection, and innovation. The banking and financial sector operates within a complex and evolving regulatory environment. Striking the right balance between promoting innovation and ensuring financial stability is a constant challenge. Regulatory frameworks vary across jurisdictions, creating compliance burdens for multinational institutions. Regulatory reforms often lag behind market developments, potentially leaving regulatory gaps or creating unintended consequences. The evolving nature of technology and financial innovation adds further complexity to the regulatory landscape.

On similar note, Anti-Money Laundering (“AML”) and Know Your Customer (“KYC”) regulations aims to combat money laundering, terrorist financing, and other illicit activities. However, the implementation of these regulations presents challenges for both regulators and financial institutions. The regulatory requirements for customer due diligence, enhanced transaction monitoring, and suspicious activity reporting create significant compliance burdens for banks.

EMERGING TRENDS

The financial services sector is accelerating its adoption of digital technology. Paying with cash, participating in in-personal meetings with financial consultants, and even using an ATM are all fading facets of financial services. From personal finance to commercial banks, digital advancement and increased financial technology is rapidly transforming the financial sector. And two trends in particular that are driving this digital evolution are: tapping into a huge gig worker opportunity and the growing influence of big tech companies.

- Gig economy workers: Gig workers have been massively underserved by financial services because they represent a high-risk demographic. But due to technological advancement in the financial sector, institutions can conduct more thorough risk assessments, which could make serving gig workers worthwhile.

- Big technological companies: Big tech companies, like apple and amazon, could grab up to 40% of the $1.35 trillion in US financial services revenue from incumbent banks, according to an Insider Intelligence report. With 54% of respondents to a Bain study indicating that they trust at least one tech company more than their own bank, consumer trust is making big tech players a huge threat in the finance industry.

- Consumer behavior and expectations: Changing consumer behavior and expectations shape the market dynamics of the banking and financial sector. Customers are increasingly demanding personalized and convenient financial services, forcing traditional banks to adapt and innovate.

- Concentration and competition: The worldwide banking and financial sector has witnessed a trend towards consolidation, leading to increased concentration of power among a few large institutions. This concentration can pose risks to market competition and financial stability. It becomes crucial to strike a balance between encouraging competition, fostering innovation, and preventing the formation of institutions deemed as "too big to fail". Too Big to Fail ("TBTF") banking institutions around the world have been considered so due to their size and systemic importance. These institutions enjoy significant market power and often face less competition.

- Sustainability pressures mount: Companies, their stakeholders, and society at large have focused more attention on climate change, thrusting sustainability requirements even more firmly into the spotlight. Sustainability strategies must be impactful and realistic. More than 8 out of 10 CEOs (83%) expect sustainability investments to produce improved business results in the next five years.

- Supporting digital payments: Digital payments are on the rise. Banks and other financial institutions are ensuring the best technologically equipped systems and infrastructure to support digital payments. This includes things like net banking and mobile banking, as well as payment processing platforms.

MAJOR INVESTMENTS

Major investments in the banking and financial sector occur on a global scale and involve various types of investors, including institutional investors, private equity firms, sovereign wealth funds, and venture capitalists. These investments can take different forms, such as mergers and acquisitions, strategic partnerships, and direct investments.

Large-scale mergers and acquisitions (“M&A”) activity in the banking and financial sector have occurred globally, reshaping the industry landscape and consolidating market power. Private equity firms play a significant role in the banking and financial sector by investing in various institutions, including banks, asset management companies, and fintech startups. These investments can drive growth, provide capital injections, and support expansion strategies.

Sovereign wealth funds ("SWF" s), which are government-owned investment funds, have made significant investments in the banking and financial sector worldwide. These funds often seek strategic investments and long-term returns. Also, financial institutions often form strategic partnerships and joint ventures to leverage synergies, access new markets, and enhance their product offerings. These partnerships can involve both domestic and international players.

The fintech sector has attracted significant venture capital investments globally, as investors recognize the potential for disruptive innovation in financial services. Fintech startups focusing on areas such as digital payments, blockchain, and artificial intelligence have received substantial funding.

The wealth management industry is at an inflection point. Market dynamics are being shaped by multiple forces, in addition to macroeconomic conditions. Other trends, such as the democratization of advice and demographic shifts, including generational wealth transfer, are also upending established business models and existing ways of serving customers. Customers are increasingly expecting holistic advice, prompting a shift from a product focus to client-centricity. These changes, however, are coming at a time when the industry is in relatively good health.

HOW WE CAN HELP?

Our team works together to advise our clients to tackle banking and financial Institutions disputes, considering the interplay between different rules and regulations. We advise our clients worldwide on various banking and financial issues, including regulatory compliance, licensing requirements, contract negotiations, and dispute resolution. We help clients navigate complex legal frameworks and ensure compliance with relevant laws and regulations.

Our team possesses extensive knowledge which spans the spectrum of banking law. We provide a full range of services, from assisting in regulatory compliances, obtaining various kinds of license and registrations to representing our clients in responding to investigations by government authorities and proving defence facilities in banking related matters.

Our team provide a full range of services which includes-

- Preparing and reviewing your regulatory compliance to ensure that it is complete, accurate, and meets all the necessary requirements,
- Gathering the required documentation, fill out the application forms correctly, and address any potential issues or gaps in your application for license and registrations,
- Negotiating and drafting contracts related to banking and financial transactions. This includes loan agreements, investment contracts, securities documentation, and other financial instruments.

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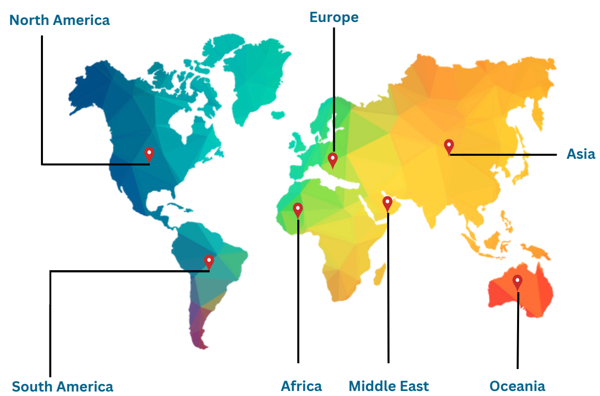
SERVING CLIENTS WORLDWIDE



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Key Contact

Surendra Singh Chandrawat

Managing Partner

surendra@chandrawatpartners.com

Connect Surendra on

LinkedIn WhatsApp

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