Don't bank on quick change

James Ferguson explains why it is taking so long for RBS to dispose of its Williams & Glyn subsidiary and looks at what the latest proposals will mean for bank competition

In March 2007, Sir Fred Goodwin's hubris and Royal Bank of Scotland's share price both peaked, with shares in the bank nominally worth £66.5bn. Sir Fred led the buyout of Dutch bank ABN Amro for almost £50bn in October that year, having outbid Barclays by almost 14 per cent and offered more cash. A year later, RBS's market capitalisation had already halved and on 30 April, 2008, the bank announced it would require a record-breaking £12bn emergency rights issue. This briefly stabilised the share price, but only until September, whereupon RBS's world fell apart. By 7 October, 2008, RBS's market cap had plummeted below £15bn and the next day the UK government announced it would step in.

The market capitalisation finally touched just £4bn on 20 January, 2009, while by December 2009 the taxpayer had invested £45.5bn and acquired an 84.4 per cent economic ownership. In the 11 years since 2007, RBS has racked up a further £60bn in losses, including the $4.5bn fine from the US Department of Justice for mis-selling mortgage-backed assets in 2018. Today it is still only worth £30bn, which makes the 71 per cent owned by the UK taxpayer worth just £21bn. It truly has been a sorry tale.

There can be little doubt that without the government capital injection, RBS as an independent entity would no longer exist. The European Commission's antitrust regulators were correct, therefore, to consider the government bailout to be state aid. RBS received an unfair advantage, particularly over smaller rivals that had curtailed their own activities sufficiently to stay solvent and were anyway never likely to have been considered "too big to fail".

In order to redress the financial balance, and at the same time bolster the bank's £32bn of core tier 1 equity capital, which was constantly being eroded by further fines for misconduct, RBS was required to sell off five subsidiaries. Sempra, Worldpay, Direct Line and Citizens Financial were all successfully sold between 2010 and 2015. But the final sale, that of the Williams & Glyn (W&G) banking subsidiary, has floundered.

Initially, the plan was for a trade sale to either Santander or CYBG, but neither wanted the entirety of W&G. The Prudential Regulation Authority (PRA) was also concerned that RBS's antiquated IT systems made separation of the unit, and re-integration with any buyer's systems, fraught with technical instability. There were other concerns that the 157-branch CYBG just would not be up to the task of integrating such a substantial add-on as W&G with its 314 branches. Considering that IT problems at RBS led to a £56m fine in 2014, it seems fair to say that the worries were probably legitimate.

> *"Concerns over RBS's antiquated IT systems helped scupper two attempts at a sell-off*

Plan B was to offload W&G as a standalone bank via an IPO. After spending £1.5bn carving a separate W&G entity from its parent, RBS management then decided that the low interest rate environment would not enable W&G to grow its balance sheet sufficiently to deliver returns above the cost of capital over the following five years.

Another problem was that same complexity of extricating those pesky IT systems. The fact that first-half 2016 profit at W&G fell by more than 42 per cent year on year (from £263m to £152m) did not help either.

Almost a decade on, RBS has reached Plan C and gained approval from European regulators for an "alternative remedies package", under which the bank has promised to pay £775m to "promote competition in the market for banking services to SMEs" by paying challenger banks (ie those with assets under £350bn) to poach some or all of the 220,000 SME customers from W&G and to pay financial inducements as an incentive to those same customers to make the move. Unfortunately for the 1.4m retail customers at W&G, they will have to shift for themselves.

Given that W&G was thought to be worth around £1.3bn but that RBS could only expect to realise about half this sum in a forced sale, the bank was already facing a theoretical loss of about £650m. This is not including the £1.5bn, and rising, it has already spent trying to unravel W&G's IT. Financially, Plan C is a good deal for RBS, capping the bank's downside losses not far below its best-case scenario while also removing a large organisational headache.

The big questions, therefore, are: who is eligible for this money, how will it be allocated and will it make any difference to competition within UK banking? Delays in setting up the independent body charged with overseeing the scheme have already left several challenger banks complaining that they are out of pocket after spending several million pounds making preparations and drafting their applications. But it has been hard to hire an appropriately qualified management team, with intimate knowledge of the banking sector, that is not also conflicted. Assuming these problems are resolved, the next stage of the process could also prove testing.

The funds that RBS will be providing are to be split into two: £275m will be allocated to an "incentivised switching fund", with a further £75m to cover switching costs; and there will be a £425m "capability and innovation fund". The intention behind the incentivised switching fund is to pay "dowries" to challenger banks accepting transferred W&G SME accounts, for example by designing preferential offers, although the challengers could use some or all of these funds for incentive payments to compensate or induce SMEs to make the move.

The money in the capability and innovation fund is intended to fund grants to successful challenger bank applicants to develop and improve their capability and IT requirements to either expand their SME offering or move into the space for the first time. But the project has been criticised. The challengers have been incensed by the costs incurred in getting these new SME account facilities ready, combined with the delays in getting independent administrators ready to allocate funds, which was supposed to be under way in the first half of 2018.

Nationwide, which is applying for £50m to fund a move into business banking by offering SMEs current accounts, is already out of pocket. Like Starling Bank, it is ineligible for a larger portion of the incentivised switching fund pot because it does not already offer business current accounts.

Metro Bank is among those that have complained that the size of the £350bn cut-off seems to have been chosen to allow Santander to qualify as a challenger bank despite it already having more than 10 per cent of the market.

> *Challenger banks have complained that they are out of pocket because of the delays*

Paul Lynam, chief executive at Secure Trust Bank, has criticised the emphasis on the provision of a business current account, which he says is a numbers game. TSB is still reeling from the fall-out from its IT fiasco, which forced its chief executive, Paul Pester, to step down in September. Meanwhile, there is a geographical mis-match between Clydesdale Bank, whose branches are in Scotland and the north, and the south where many of W&G's 220,000 SME customers are based.

In short, while RBS had to be punished under European Commission rules for receiving state aid, *pour encourager les autres* if nothing else, it seems unlikely that trying to force it to pay other banks to take its W&G SME customer base off its hands will either go that smoothly or do much to intensify competition in UK business banking. Challenger banks will continue to be challenged by their three main nemeses: scale, IT costs and punitively restrictive capital constraints using standardised risk weights. None of that is going to change anytime soon. ■

__James Ferguson__ founded the MacroStrategy Partnership in early 2013. After starting his career at Nomura more than 20 years ago, he worked for a variety of bulge bracket firms in both London and Tokyo, rising to chief strategist roles at Pali International and Arbuthnot