Free finance essay: royal bank of scotland crisis

Literature, Russian Literature

1. INTRODUCTION

The need for banks and financial institutions to grow beyond their normal businesses of accepting deposits and providing loans, into global giants that are diverse and often engage in sophisticated practices has been embedded as the pure nature of capitalism and market liberalisation. In the most recent decade, most global economies and organizations enjoyed unprecedented growth on the back of trade liberalisation and increasing financial services sophistication.

The need for these organizations to grow led to unscrupulous practices such as risky loans, high bonuses and reckless investments, together with high leveraged practices, all of which have been recognised as the major reasons why these institutions were hugely exposed to the financial crisis. Banks were the most affected, primarily because they were one of the major starters. They engaged in risky lending to businesses and individuals, invested in securities backed by subprime assets, and expanded like they intended to take over the world – mostly with leveraged funding and customer deposits. If they had not invested so rigorously in these risky securities, a huge number of those banks that were bankrupted or needed government bailout would have still been standing. They had to write down huge consumer and business loans that were defaulted, and also write down on the value of collateralized debt obligations they had in their portfolio. This led to huge losses, and depletion of capital reserves that prompted the intervention of the government in a huge number of global banking businesses.

This essay therefore aims to analyse the effects of the economic crisis on RBS Group, parent company of Royal Bank of Scotland, and NatWest. The group's financial, operating and investment activities would be analysed in this study, with the aim of establishing the reasons why they fell the way they did compared to other UK banks, what could have been done better to alleviate such heavy losses, and what they could do now to repay government shareholding, and renew customer and investor confidence.

A background of the bank's operations and investment activities would be outlined in the following chapter, followed by an analysis of what went wrong, its effect, steps that have been taken to alleviate such effects. Then finally an analysis of the bank's current state compared to its rivals, and the effects of macroeconomic and industrial factors on its current and future operations.

2. BACKGROUND – ROYAL BANK OF SCOTLAND

The Royal Bank of Scotland group is a British banking and insurance holding company based in Scotland, and operating in Europe, North America and Asia-Pacific. Its main subsidiaries include the Royal Bank of Scotland, NatWest, Ulster Bank In Ireland, Citizens bank in the US, RBS Coutts, Churchill Insurance, Direct Line and Privilege (RBS, 2009).

RBS currently provides banking, private banking, insurance and corporatefinancesolutions to over 40 million customers worldwide (25 million in the UK) and 1 million small businesses. In terms of Group market share, RBS Group is currently the second largest provider of current accounts to

customers in the UK (Mintel, 2009). Prior to the 2008 sub-prime mortgage financial crisis, RBS was the world's largest company by assets, fifth largest in the world by market capitalisation and 10th largest company in the world (Financial Times, 2009).

RBS was established in 1727, and now has 2, 278 branches and 118 business centres in the UK alone (RBS, 2009). RBS' revenue and PBT has grown consistently, up until 2007 where it recorded a record turnover and PBT of ? 32. 3 billion and ? 9. 9 billion respectively. However, following write-downs on recent acquisitions and losses suffered during financing activities, RBS posted the greatest ever loss by a British company of ? 34. 5 billion profit after tax in 2008 (RBS Financials, 2009).

3. ANALYSIS OF RECENT ACTIVITIES

RBS Group has grown over the years through a series of acquisition and expansion across several market places in the UK, US, Europe and Asia Pacific. The organization expanded into new markets and increased market share through organic growth and acquisition.

Its major US acquisitions were in 1998 and 2004 when the bank acquired Citizens Financial Group and Charter One Bank respectively (RBS, 2009). The bank also acquired NatWest on 11th of February 2000, when it was declared the winner of the hostile take over battle of the bank against Bank of Scotland. RBS also acquired a 10% stake in the Bank of China for ? 1. 7 billion in August 2005, in order to further its international expansion into Asia-Pacific markets (Gumbel, 2009).

These acquisition activities in no way resulted in any shortcoming on the bank, but they even catapulted it into one of the biggest companies in the world. They made RBS a major player in the US and Asia retail and corporate banking industry, and also enabled it to leverage back office operations across the whole group. RBS had strong financials (Illustrated in figure 1). The figures show that up until 2007, its total assets, revenue and operating profit had been increasing consistently mainly as a result of these growth activities. These figures illustrate that the company was very strong and thereby never warranted a financial collapse or a takeover by the UK government. Then what went wrong?

Similar to any other UK or International bank, RBS suffered impairment charges against bad loans made out to bankrupt companies such as the American conglomerate LyondellBassell (? 1. 5 billion), and also about ? 1 billion tied down in assets in Icelandic banks and Lehman Brothers (RBS, 2009). According to the Financial Times (2009) the bank also made losses through its global banking and markets division that was responsible for investing in Bernard Madoff's Ponzi scheme, US subprime market and also in Lehman brothers. These losses resulted in huge capital shortfalls within the bank and impairment charges of ? 8, 072 billion, but are still commonplace amongst other UK banks like Barclays and HSBC that made provisions of ? 5, 419 billion and ? 24, 937 billion respectively within that same year, but still made reasonable profits and paid dividends to shareholders (Reuters, 2010).

A vast majority of RBS' shortcomings, huge loss andfailureduring the credit crisis can be attributed to its acquisition of ABN Amro. It is widely believed

that RBS hugely overpaid for ABN Amro and did not get the better of the deal (Ram, 2007). In October 2007, RBS led a consortium with Belgian bank Fortis and Spanish bank Banco Santander to acquire the Dutch bank ABN Amro for ? 49 billion after a failed bid from Barclays Plc. RBS claims its share of the ABN Amro acquisition was ? 10 billion, which was paid for mostly with cash (Kennedy, 2009). The consortium that was made up of RBS, Santander and Fortis, carved up and parted with different divisions of the bank. While Santander made forth with ABN's Brazilian business Banco Real, and its Italian business Anton Veneta; RBS made do with the bank's wholesale and Investment banking division, which already had a huge number of risky assets and was most exposed to the subprime mortgage markets (Ram, 2007).

RBS (2009) claimed that the acquisition would have boosted the bank into one of the formidable banking entities in the world if it acquired the right asset classes and done its due diligence. However, Griffiths (2009) believed that its subsequent failure was as a result of the exposure of ABN Amro to subprime mortgages, and the fact that the bank in itself overpaid and therefore severely depleted its capital base. However, we believe that the bank's implicitcultureof growth through acquisition is what prompted the acquisition spree, and even if the chairman – Fred Goodwin – had been forewarned about the global crisis, he may have still gone ahead of the deal. The bank's willingness to become the world's largest bank, has therefore catapulted it into one of the world's greatest bank failures.

4. WHAT HAPPENED?

RBS' fate and the effects of the credit crisis on its operations did not really materialise when it began venturing on a range of capital raising and divestment activities. The company floated a ? 12 billion 11-for-18 rights issue, the largest ever in the history of Banking; sold Angels Trains, its train leasing subsidiary for ? 3. 6 billion and a 50% stake in Tesco Personal Finance for ? 950 million. All these activities were in order for the bank to shore up its capital reserves following the acquisition of ABN Amro (The Times, 2009; Duncan 2008). Hurdle (2010) stated that several investors where weary of the extent to which the bank was exposed to credit mark downs and risky assets, however since the financial results were not yet out and investors had no reason to be concerned about the state of the bank's financials, the rights issue was fully subscribed.

However on the 13th of October 2008, HM Treasury announced plans to inject an initial ? 20 billion of new capital into RBS. In return, the Treasury would have a say in how the company is run, cut bonuses handed out to bankers, protect customer deposits and also help protect these banks' toxic assets (Gumbel, 2009). RBS then intended to raise a seconds right issue of ? 20 billion from investors, which was shunned as investors only took up 0. 24% of the shares being offered as they were being offered at 65. 5p per share and the shares were already trading on the floor at 52. 7 per share (Duncan, 2008). Shareholders were also highly concerned about the potential nationalisation or ownership of the bank by the government, which would have profited the customers, but not the investors and not even the taxpayers (Gumbel, 2009). This resulted in government taking up the ? 15billion that they underwrote for the issue, after initially investing ? 20

billion of taxpayer funds in the bank. On the 28th November 2008, RBS was 58% owned by the government after the unsuccessful rights issue.

The fact that the government now owned 58% of the bank led to investor resentment regarding the bank, as they feared that the government would interfere in the bank's operations and therefore prevent business as usual. However, these feelings where nothing compared to the earnings announcement on the 19th of January 2009 in which RBS expected to see write downs of ? 20 billion following the purchase of ABN Amro and operating losses of over ? 8 billion operating loss due to its exposure to the sub-prime market in the US. Shares fell 68. 8% to 11p (Dunkley and Griffiths, 2009). The write downs associated with its acquisitions were due to the fact that the bank realised it overpaid during the acquisitions and the assets that had been paid for could never be sold for those prices, therefore confirming Ram' (2007) allegations. Following the stock freefall and huge investor resentment, the government agreed to increase stake in RBS to 70% by converting ? 5 billion in preference shares into normal shares thereby effectively controlling the company and eliminating the compulsory dividend payments of ? 500 million regardless of whether the company mademoneyor not.

Figure 2: RBS's stock market prices from 30/01/07 – 28/01/10. Source: Reuters (2010).

Most other banks, as discussed earlier also suffered impairment charges with regards to credit and exposure to subprime mortgages, however they did not necessarily need government bailout, with the exception of Lloyds TSB that

was encouraged to acquire HBOS. According to an article on BBC News (2009), the acquisition of ABN Amro was regarded as " worst and most ill-time takeover in history". By the 20th of January 2009, a day after its earnings announcement, RBS' value dropped to ? 4. 5 billion from ? 75 billion two years earlier (Times online, 2009). It was now worth more than half the cash it paid in the deal to buy ABN Amro. RBS' current market value is between ? 18 –? 20 billion (Reuters, 2010)

5. STEPS TAKEN TO ALLEVIATE

The effects of the financial crisis, especially on retail and commercial banks, really hampered consumer confidence. It was now theresponsibilityof the UK government to come up with schemes and plans in order to help cushion and bailout the banks, in order to prevent an overall mass resentment of the banking industry. The Asset Protection Scheme was therefore introduced in February 2008, which RBS committed to by signing up ? 325 billion of toxic assets (RBS, 2009). The fact that the bank had that much toxic assets (5. 5x its total shareholder equity and 13% of total assets), makes one wonder about the effectiveness of financial regulation in protecting the banks' customers. If there was ample regulation that limited the amount of toxic assets that each bank could invest in, a much lesser percentage of toxicity could have been protected, thereby significantly affecting the UK Taxpayers (Slater and Ferreira-Marques, 2010). However Duke (2010) asserts that though these banks did engage in risky investment practices, the level of toxicity of these assets were not really known due to the sophistication of the financial system and collateralized debt securities. The scheme however

helped to protect RBS' assets against loss of future value. Signing up to the scheme effectively increased government shareholding to 84% of the bank, effectively part nationalising the bank, and leaving shareholders with only 16% shares in the company.

The organization now having learnt its lesson (under the thorough supervision from the UK government) has now opted to divest a range of assets such as its 4. 26% stake in Bank of China ($1. 6bn), and about one fifth of its businesses, in a bid to concentrate on its core markets (Murden, 2010). Recent developments include the 3Q 2009 loss of ? 2. 2 billion by RBS, particularly attributed to its sale of non-core assets; recent plans to divest early from the Asset Protection Scheme and also plans to sell off its Insurance assets, commodity trading business (RBS Sempra), about 318 bank branches (Guardian, 2009) and a ? 1 billion pledge to UK manufacturing companies (RBS, 2009).

The following chapter would discuss the current effects of macro economic and industrial factors on the affairs within RBS.

6. MARKET AND INDUSTRY ANALYSIS

Following RBS' record loss blunder last summer, the government stake within the organisations has consistently risen from 57% following a failed rights issue, to 70% following share conversion, and now 84% following its decision to join the Asset Protection Scheme, thereby effectively part nationalising one of the world's largest banks. Shareholder equity has been diminished to as low as 16%, and the government now have total control on

the activities within the organisation. That is a severe blow for an organisation whose main aim was to deliver profits and dividends to its shareholders, now it is managed like a welfare bank, selling off international assets, being less competitive and concentrating on its core market, in which the banking industry is already matured (Duke, 2010).

For all banks in developed, and even in developing countries, their affairs and future especially in the economic climate, is closely tied to government regulations. A proper illustration would be when President Obama announced plans to carve up banks, prevent them from owning hedge funds, private equity and proprietary trading desks. The shares of most banks that were engaged in these activities engaged in a freefall including that of RBS, which owns a joint venture RBS Sempra. The effect of this announcement would have meant that banks would have to carve out their investment banking divisions, which already accounts for a vast majority of profits in these organisations (Murden, 2010).

The US President's announcement is the least of RBS' problems. It is under intense regulatory pressure both from the EU and UK, to carve out its subsidiaries and make it much more slimmer and less competitive. It is said to be a punishment for the bank due to its risky practices that warranted government bailout. However, a decision for a bank to sell strategic business units and bank branches does not come likely. It would severely impact on turnover and profits, group shared services, and its market share in those core markets. RBS is being asked to sell RBS Sempra, a JV that made a profit of a profit of over $600m in 2008 (Murden, 2010). It is also being required to

sell its Asian business, its Insurance business and up to 318 bank branches, in a bid to shore up its capital and repay the UK taxpayers. These businesses are thriving and were the core of RBS’ core strategy ofleadershipand expansion. The sales of these assets would severely reduce the bank’s assets, customer base and market share, and It may not be able to compete effectively in other markets apart from its traditional Retail and Corporate banking (Gumbel, 2009)

Also, with current public outcry concerning its bonus payout, there is bound to be more trouble for the organisation with regards to recruiting and retaining high performing staff. For instance, the public is concerned that the bank wants to pay out about ? 1. 5 billion in bonuses, amounting to an average of ? 85, 000 per staff, when competitors such as Barclays and JP Morgan paying more to their staffs (Patrick, 2010). Even if the bank were government owned, curbing and paying out minimal bonuses just like this would push staff away to competitors that are able to pay competitive packages and are not government controlled. According to Johnson (2009), the bank has already lost about 1, 000 staff to competitors such as Barclays last year, and could lose even more staff if the row with the government over bonuses continues.

The organisation is also said to be suffering an increasing threat of credit markdowns, especially in its loans granted to Four Seasons, and also in Dubai’s real estate crisis (Slater and Ferrerira-Marques, 2010). These loan write downs reflect on the practices that the bank had always engaged in, and calls for stricter risk measures that ensures the bank faces lesser threat

of write downs in the future. Apart from these measures and effects, the bank is also facing a customer crisis, in the way in which customer perceive the bank. If the bank continues to engage in credit markdowns and selling off its assets, customers may flee for more stable organisations that do not necessarily have that much government oversight. The same could be said for its employees and investors as well, with the government controlling all decisions.

There are also some legal issues affecting the organisation, as some of its shareholders are suing the bank over its right issue in 2008. They attest that they were not made fully aware of the risks associated in the ABN acquisition prior to their signing up for the shares. These investors paid 200p for RBS' shares, only for it to drastically lose about 95% of its value months later when it announced its biggest annual loss (BBC News, 2009).

In terms of its industry analysis, the company is at a severe disadvantage when it comes to competitive rivalry. Due to its government ownership and uncertainty regarding its future, the company is struggling to compete for customers, employees and investors, against other formidable strong opponents like Santander, Barclays and HSBC. The bank has to sell its Insurance, private equity and over 300 branches. These would severely dent investor and employee confident and market share in a number of core markets. The bank also has to sell its transaction services business.

Based on figures in Table 1 below, RBS still accounts for 18% of all current accounts in the UK, with the lowest market cap of about ? 21 billion (18th January 2009). Thereby illustrating that it is still able to compete effectively

in the UK market, but to what levelIf the government keeps meddling in its affairs?

Current Account Market Share

Market Cap (? billion)

Total Assets (? billion)

PAT (? million)

Lloyds Banking Group

25%

? 36

? 1, 195

? 845

RBS Group

18%

? 21

? 2, 508

-? 38, 513

HSBC First Direct

14%

? 122

? 1, 736

? 6, 498

Santander

14%

N/A

N/A

N/A

Barclays

13%

? 36

? 2, 320

? 5, 287

Table 1: Market share of top UK banks. Source: Reuters (2010)

The economic climate, and the government's need for new competitors have severely reduced the barriers to entry into the banking system. It was recently announced that Blackstone Group and Virgin planned to open banks

in the UK (BBC News, 2009). And guess whatThey plan to do so by hiring off staff and buying off bank branches that are being sold by RBS. The market capitalisations of most banks are less than 40% of what they were prior to the economic markdown. Even the ABN Amro that RBS bought for a large amount would not be worth that same fee now. Therefore there is a huge opportunity for start-up banks or even international banks to come into the market and compete effectively with existing players.

The major suppliers to the industry now are invariable the government who are providing insurance schemes and bailout funds to RBS. The government has enormous power and has been able to exercise it repeatedly in directing the actions of the organisation. Buyers, being bank customers also are weary, and the unwillingness of customers as a whole to join the bank can severely impair the bank’s ability to attract deposits and therefore make more money by lending it to other individuals and businesses. However, the banking industry is crucial in any economy, and is needed to provide credit to businesses, therefore there is no substitute product. This means that the government may continue to support the companies for as long as necessarily, so as to increase liquidity in the economy and provide businesses with adequate loans.

7. FUTURE PROSPECTS

Based on the information gathered and analysed in this study, it can be ascertained that RBS has a very bumpy road ahead. It has 84% government shareholding, and up until when it would be able to raise ? 17, 640 million (84% of current market cap – ? 21bn), it would continue to have government

oversight, and its operations, investment and financing activities would continue to be severely impeded. Its current aggressive asset sales that's its current CEO – Stephen Hester is embarking on is more like a total opposite from the aggressive expansion strategy of former chairman – Fred Goodwin. As to whether RBS would return to profitability in the nearest future, we do not know. But the bank is still announcing credit write offs, so it doesn't look too optimistic anytime soon.

Also, its strategy of winding down businesses, would severely reduce revenue and profitability figure in the short run, but with a competitive concentration on its core market, and a number of core brands, it could still compete effectively and drive growth locally in UK and EU. However, as forecasted by Norman (2009), that would not be for a few years to come. The bank is still going to find trouble attracting and retaining staff, and its customer base may not grow as well as it used to. However this is a great opportunity for the organization to draw up a new divestment strategy that would ensure it gets rid of regulatory oversight and returns back to profitability, shareholder influence and dividend payment in the nearest future.

8. CONCLUSION

RBS has shrunk in recent years, from a formidable force in global banking, to a part nationalised bank with intense regulatory oversight – that seems like punishment – from both the UK and EU regulators. The bank's shortcomings occurred mainly as a result of its acquisition of ABN Amro, and not necessarily due to credit markdowns and subprime exposures. Its acquisition

was been fuelled by a culture of aggressive growth and expansion in foreign markets, which delivered exceptional growth within those periods.

With the advent of the financial crisis, and near bank failure, came a 84% shareholding lifeline by the government, and with that came an intense regulatory oversight that has severely impeded the bank's asset base, and even promoted a de-establishment of some core and noncore businesses. These factors have impeded the bank's competitive strength with regards to current and prospective employees, shareholders and even customers, a disadvantage that may take some years to alleviate. It is therefore recommended that the bank drafts an achievable repayment plan over the coming years for it to be rid of government shareholding and return itself to competitiveness – albeit with a new lesson learnt.

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10. APPENDIX

2005

2006

2007

2008

Revenue (? bn)

? 25, 569

? 28, 002

? 31, 115

? 31, 413

Total Assets (? 100 bn)

? 7, 768

? 8, 714

? 19, 005

? 24, 017

PAT (? bn)

? 5, 558

? 6, 497

? 7, 712

-? 34, 542

RBS 2005 – 2008 Financials