DISINTERMEDIATION

L. Burke Files

Disintermediation

It's a big word that loosely translates into the vernacular as "cutting out the middleman".

As a financial investigator I often get to see trends developing when our client's needs and nature shifts. In the early 2000's our firm was in demand to aid in the fact finding process for bank's commercial loans. In mid 2005 on to 2008 "The economy is so good were not making any bad loans" These are the exact worlds from a loan officer at Wachovia, Not surprising we had zero due diligence work from banks. In 2007 to 2009 the engagements were on asset recovery matters. The banks and financial intuitions were looking to recover from borrowers on bad loans. Most of the work was on loans for 2 million dollars and up and bank's management tended to wish to be very controlling on what hours could be worked and what resources we could use. We turned down most engagements as with such stringent controls we were unable to work effectively. Discount investigations has a good deal in common with discount plastic surgery in that there is a large gap between a client's expectations and a competent professional willing to meet those expectations. From 2009 to present we have been very busy working with banks and other financial institutions with a toxic "boom time" legacy issue - compliance. Banks and financial institutions who a) did not understand the regulators were serious and b) who did not take the opportunity during the good times to invest in compliance infrastructure, are now being forced to make the investment and facing significant fines for past failures. Further these failures are prompting yet more rounds of regulations with which they must comply. The fines origins have more to do with initial failures in KYC procedures that lead to systemic violations of anti-money laundering statutes, violations of anti-bribery and corruptions statutes and dealing with prohibited parties such as specially designated nationals, as opposed to any malicious intent of the institutions.

At the same time as the KYC failures and oversight failures are coming to light concurrently with fines for those failures, the regulations hitting the financial community; such as Basel III, legislation on what banks can and cannot do with their money, uses of depositor's money, fees they can and cannot charge are creating a very difficult time for bankers.

But this tumult is really not new, history can provide us with several lessons of crisis and overreaction... I have had enough trips around the sun and years in finance to have seen this play based upon, - failure, than panic followed by legislative redemption - more than once...

- *Problems in the early 1970's (Anyone remember Bernie Cornfield, IOS and Robert Vesco?)*
- *The recession of the early 1980 and the high interest rates when Volker came in and forced deleveraging on the US banks and households.*
- *Bank and S&L failures of the mid 1980's*
- *Failure of several public companies in the 1990's that lead to Sarbanes Oxley*

Each time newsworthy events occur, a new wave of politicians declares a crisis in current law and regulations and work to pass a new tome of laws and regulations to insure that this (the crisis of the moment) will never happen again. This time, I think the over anxious politicians maybe correct, albeit for all of the wrong reasons.

The EU banks are estimating that they will be required to invest over 30 billion dollars on compliance and the US financial community, having not adopted Basel II, is expected to invest 110 billion on compliance. Further, the capital controls on banks, in particular capitalization requirements and what is or what was tier I, II & III capital is forcing the hand of the banks to re-order their investments and holdings. The banks' reactions have been to deleverage as fast as they can, restrict new loans, and stock up on short-term government securities.

A similar legislative fusillade directed at the securities industry in 1980s and 1990s in the US killed the smaller company IPO where the cost of raising capital by small companies, according the SEC own studies, ranged from 18 to 26 cents for every dollar of equity raised. It was just too expensive to comply with all of the regulations for the small companies. The small public IPO was gone, only private money or fund money was available. So the wealthy and knowledgeable now prefer private funding which to invest and take only private money for their ventures, just as they avoid public air transportation and prefer private aircraft.

For us the biggest shift in clients we have seen has been in the last 18 months. All of the due diligence work is now coming private investors, private funds, and family businesses. The banks have curtailed lending let alone investing and the IPOs left are mostly end of growth cycle stock sales by principals such as, Blackstone Group, GroupOn, Facebook…

The private lender/investor does not care what a rating agency has to say. They do not waste their time with opinions or recommendations from disintermediated middlemen such ratings agencies, bankers or brokers. The private investors are collecting from an investment prospect not only complied financial reports, audited if possible, but also the raw operational and commercial intelligence they need - no require - to make their fully informed investment choice.

The private investor's trend away from the brokers and banks has been so pronounced that the regulators are now crowing about all of the "shadow bankers" as though these enlivened market participants are to be ground under the regulator's heal. These "shadow bankers" are as much the creation of the regulators as they are enlivened free market participants. For if it was not for the regulators myopic zeal, these "shadow bankers" would not exist.

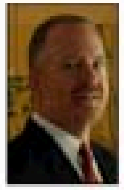
The effect is clear.

The market is working its way away from big concentrated market participants that are "too big to fail" and seeking niche knowledge toward better profits in the "shadow banking" community. This community is also providing real capital to business that otherwise would not have access to capital. It is relieving the infrastructural stresses on central banking and underwriting and providing for a more diverse and healthy capital market.

The regulators are right about the shadows. There are long shadows being cast, two very distinct long shadows. As the sun sets in one place it rises in another and the long shadow at sunset is the silhouette of a long armed regulator while the sun is just starting to shine on the private investor.

We, the OFC community, must continue to work toward inventing and better servicing the niche clients of today and tomorrow. The model of a large concentrated assemblage of professional staff in one location is the old model, as few firms can support the size and breadth of staff required to serve the varied and technical needs of today's client base. Just as the disintermediation of banks and brokerages is occurring the same holds true for the OFC professional service field working from the old models. The modern OFC firms are using a service model where by the client has a single point of contact, where that person takes care of coordinating support for that client's needs. The firm behind the single point of contact will rely on a small support staff, but also a large and varied group of professionals who are SMEs in their field. Fields such as art curators, transaction processing, web based business, trust law, tax professionals, insurance experts, intellectual property and critical information specialists, and one of my favorite disciplines - due diligence. This deconstructed more nimble OFC service provider is the form of the modern OFC provider of today and tomorrow. A close relationship with the client is paramount to recruiting the client, and a heretofore unheard of depth is addressing the modern client's needs is the key to long-term client retention.

Mind the trend indicators - be prepared or be disintermediated. –



L. BURKE FILES, CDDP (lbf@feeinc.com) Mr. Files is a recognized international expert in; Due Diligence, Financial Investigations / Asset Recovery when the Due Diligence has not been done, and the creation, defense and valuation of IPCI - Intellectual Property and Critical Information. Case assignments have covered over 50 countries and billions of dollars in assets. He is member of the Board of Advisors to the Association of Due Diligence Professionals and President of International Association against Fraud and Corruption. He has been quoted in articles, has authored articles, and has authored 4 books - the most recent is Due Diligence For The Financial Professional, 2nd Edition - winner of two book awards, and no one was more surprised than the author!

Financial Examinations & Evaluations, Inc.
P.O. Box 27346
Tempe, Arizona 85285
T (480) 838-1728
F (480) 491-9439