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Policy towards the financial crisis: a bank economists' perspective

European Banking Federation (EBF) – a.i.s.b.l.
Brussels – April 2009

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Abstract

In this paper, the senior economists of the European Banking Federation's Economic and Monetary Affairs Committee (EMAC) consider the consequences for the banking sector of the authorities' reaction to the current financial crisis. The paper first looks at the expected economic impact and policy response as seen at the moment of writing. It then turns to the role of innovation in financial markets, with particular reference to financial techniques such as securitisation and the Originate-to-Distribute model, and its added value to the functioning of the financial system. The subsequent section looks at past lessons: from the Great Depression, and the more recent experience of the Swedish and Japanese crises of the 1990s. The final section of the report puts forward a number of considerations –as seen by the EBF's EMAC– that must be taken into account when shaping future financial policy.

Introduction

Since August 2007, the financial markets have been hit by an escalating crisis, thus weakening confidence in financial markets and institutions, and destroying value. The European Central Bank (ECB) and European Union (EU) policy-makers have acted quickly, at short notice, to provide substantial and coordinated support for the markets. This support has taken a range of forms:

i. from the ECB: an enhanced intermediation role on the money market (more liquidity injections and a correspondingly greater absorption of excess liquidity through the day-to-day deposit facility) and the extension of maturities on the repo market;

ii. from governments: undertakings in support of protection for depositors, bank recapitalisation and sovereign guarantees for newly-issued senior secured debt, as well as the outright rescue of some financial institutions.

In addition to these crisis-management initiatives, recent events have given rise to measures with a longer term perspective, intended to rebuild confidence in the future of the banking system and prevent the same problems from recurring. The proposals of the de Larosière Report and this month's G20 discussions, underlined by the political commitment of major non-EU nations such as the US and large rapidly developing countries, are likely to give strong impetus to this process of reforming governance in international financial markets. Further short-term measures could aim at dealing with distressed assets on bank balance sheets to repair the erosion of market trust and prevent "fire sale" liquidations and the need for further recapitalization of viable financial institutions.

Analysis of the financial crisis provides arguments relating to many issues, particularly the link between the unbridled expansion of liquidity and sharply declining interest rates, debt and the development of new financial instruments in the quest for higher margins. Financial reform involves a number of layers of activity: it is a macroeconomic issue, essentially and directly involving governments and central banks; and, on the other hand, it touches on the regulation and supervision of institutions and markets, where political responsibility is clearly taken through technical mediation, performed by dedicated supervisory authorities. Not least, it implies ongoing cooperation with the financial industry. The development of new policy is therefore highly complex. While official institutions must be set up or strengthened on an international level, those responsible for the supervision of financial institutions or markets are, at first sight, different from those responsible for macroeconomic balance, even though they must work together.

The banking industry is already adapting to the dramatic events and is engaged in the resulting policy debate. It must react to the severe economic crisis, as well as prepare to absorb the regulatory reaction which has been unleashed.

Consequences of the crisis

Cost to the economy

The global economy is in the midst of a deep downturn, as an adverse feedback loop between the industrial and services sectors and financial sectors is taking its toll. The dramatic worsening of the financial crisis since mid-September 2008, when Lehman Brothers was allowed to fail, has generated historic declines in confidence and severe disruptions in credit intermediation. The precipitous decline in activity across the globe is damaging the financial sector even further.

The full cost of the crisis for the banking sector will be very substantial, obliging the industry to contract. In its latest Global Financial Stability Report Market Update[1], the IMF estimates the potential deterioration in the US-originated credit assets held by banks and others from EUR 1 trillion (USD 1.4 trillion) in the October 2008 GFSR to EUR 1.5 trillion (USD 2.2 trillion). The IMF believes that much of this deterioration has occurred in the mark-to-market segment (mostly securities), especially in corporate and commercial real estate securities, but degradation is also occurring in the loan books of banks, reflecting the weakening of the economy.

The economic fall-out from the crisis, and from the recession in the banking sector in particular, is likely to be significant. Rough estimates show that in terms of GDP loss, taking into account only the period of 2008-2009, the difference between the cumulative growth rate of world GDP expected before the start of the crisis (IMF forecast from April 2007) and that expected nowadays, is around 6 percentage points.

[1] IMF Global Financial Stability Report Market Update, 28 January 2009 (can be accessed here: http://www.imf.org/External/Pubs/FT/fmu/eng/2009/01/index.htm)

Forecasts have yet to catch up with the recent public budgetary initiatives and other policy changes, notably the stimulus package recently unveiled by the US government. The EMAC's own estimates suggest that annual world output growth could decelerate to as little as -0.2% in 2009. The outlook for 2010 appears highly uncertain, and the timing and pace of the recovery depend critically on strong policy actions. The general EMAC expectation is however that next year the world economy will gradually start picking up pace, although the downside risks to the outlook remain substantial. The overarching risk revolves around the possibility of further corrosive interaction between a more severe contraction in global economic activity and even greater and more prolonged financial strains than currently envisaged, particularly if policy implementation falls short.

The broad policy actions to resolve the financial crisis have not yet achieved a decisive breakthrough. While there are pockets of improvement in some markets where policy intervention has taken place, financial markets remain under heavy strain and systemic institutions are still perceived as fragile. Challenges persist across a wide range of markets and instruments.

Changing banking structures and businesses

While it is too early to draw precise conclusions about the financial cost of the crisis for banks, **banking structures are already changing** and will continue to evolve in reaction to the crisis and to the recession. An immediate consequence has been an increase in levels of public intervention[2].

At the start of the crisis, it seemed that the trend of recent years towards **consolidation of the European banking sector (Mergers and Acquisitions, M&A)**, much of it cross-border[3], was continuing or even intensifying, following the assumption "the bigger the better", in order to limit or to avoid the turbulence. This initial activity was partly the result of crisis-management, for the banks which were experiencing funding difficulties, and partly a response to the opening up of new commercial and strategic opportunities. Commercial logic would suggest that, as demand for banking services declines and competitive pressures grow, banks will search for new sources of revenue (particularly in lower risk businesses) and new ways of cutting costs, such as rationalisation. However, the momentum towards consolidation has been overtaken by the pressure to seek security and in some cases support the banking sector. The decision by some governments to take equity stakes in, or nationalise, parts of their banking systems has been the most striking structural change in recent months.

Banking services are being adjusted to the changed outlook. Some banks, particularly in the investment business, have fallen victim to the loss of faith in models based on wholesale funding. Because of the

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[2] For an EC list of state aids, please visit:
http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/09/111&format=HTML&aged=0&language=EN&guiLanguage=en

[3] According to PriceWaterhouseCoopers 2006 report (to be found here:
http://www.pwc.com/Extweb/pwcpublications.nsf/docid/8EC8B5AD78C51CBE85257164003D6FF4/$file/banking_consolidation.pdf), "The cross-border consolidation of the European banking industry has been under way for some time with 274 transactions (EUR 158 billion) announced during the last 10 years."

current drive for security, there is a renewed focus on simpler, traditional products. Some activities which are currently out of favour, such as securitisation, should, due to their intrinsic merits, see a revival when conditions are calmer, provided that levels of transparency, reporting and regulation are seen to be commensurate with the risks.

Probably the most significant effect of the crisis on the banking business will be the pressure to rebuild capital ratios and restore balance sheets. Banks, alongside their customers, are undergoing a phase of **deleveraging**, which will take some time to complete. There is a risk that the drive to strengthen balance sheets for prudential reasons will move too quickly, putting further pressure on asset prices. Meanwhile, traditional banking structures and activities, based on the garnering of deposits and on services attached to basic banking activities, will be at a premium; competition in these businesses has already sharply intensified. The fierce demand for deposits is putting upward pressure on interest rates in some markets.

Internal bank processes have been overhauled, particularly in the areas of risk-policy and governance. These initiatives are taking place against a background of regulatory change, with the Capital Requirements Directive (CRD) having only entered into force at the beginning of 2008. Changes have been introduced, for example, to credit approval systems to ensure that due diligence is undertaken in the assessment and pricing of risk. Banks are also adapting their **remuneration policy** to reduce incentives towards excessive risk-taking.

The regulatory response

Some valuable policy lessons are to be learned from the crisis. It is clearer than ever that Europe's banks and markets are operating in a **global environment** and are part of global structures. European Union policy makers pressed forward with building a single European financial area primarily to enable the EU economy and society to flourish in a world context, with its financial institutions, corporations and consumers better able to benefit from economies of scale and more efficient allocation of resources. An essential ingredient for such success is the quality and flexibility of the regulatory and supervisory framework which underpins the commercial markets, and its coherence with that of other important international markets. The crisis has demonstrated the strengths of the structure of economic and financial governance in the EU, while highlighting the areas where improvements are required.

Governments at all levels are considering an array of new regulation in response to the bursting of the financial bubble. However, if financial market regulation needs fixing, it may be because the old regulation needs improvement and better application, rather than that there is a need for new regulation. Indeed, a wide range of already existing regulation is now being revised under the G-20 umbrella: the solution for regulatory supervision is being sought, deposit guarantee schemes have been reviewed, accounting standards are being revised, and credit rating agencies are to come under regulatory scrutiny, to name but a few. In the case of supervision, policy makers are working with renewed effort to repair gaps in the financial services legislation, particularly in supervisory cooperation and architecture, and financial reporting.

The new spate of regulatory activity is likely to impact directly on some of the banks' business lines, in particular in the trading books, where the crisis arose. The crisis was triggered by problems in the US sub-prime market, but a variety of factors contributed to the implosion of this market and spread its effects into other countries and markets. At a time of excess liquidity, intense competition for returns and the globalisation of the financial markets, **financial innovation** reached an unprecedented level of complexity. The Originate-to-Distribute (O2D) model, combined with ambitious securitisation programmes, allowed for wide and efficient distribution of risk while diversifying banks' revenues. It brought high returns on investment on the one hand, but failed to take account of the inter-connectedness of the world's financial markets and actors, which limited the real spreading of risk.

The O2D model is now in line for some changes, and securitisation markets have withered, but these models need not be discarded. Instead, the underpinnings of the markets need to be strengthened; in particular by enhancing the information available to market participants, and by changing incentive structures, and risk management practices.

Special care needs to be given at this stage to policy actions that, due to the severe situation in the markets, have not benefited from an optimal degree of coordination at international level. Within the EU, this applies in particular to the possible unintended consequences of the interplay of the different government-led initiatives designed for the banking sector by Member States. There is always a risk that even well-intended regulation becomes excessive, thus limiting or postponing the prospects of economic recovery.

Lessons from the past

Previous financial crises have taken place in an economic and financial system which was fragmented by politics, geography, markets, tradition and culture to a much greater extent than today. These divisions provided fire-walls which may have helped to contain problems and allowed remedial measures to be directed more accurately. Despite the important differences between our globalised world in the 21st century and those times, lessons were learned in the past which have helped the authorities to act quickly and more effectively now.

Nonetheless, there is no ideal solution, nor a single solution for countries which are experiencing the crisis in different ways. One of the most difficult tasks for policy-makers is to decide how to share the price of the rescue, and avoid perverse effects which will themselves cause damage to the financial system.

The **Great Depression of 1929-33** has provided some lessons in behaviour to avoid during subsequent crises. Notably, at that time the US Fed was determined to preserve the convertibility of the dollar under the Gold Standard. In contrast to its recent behaviour, in the 1920s the Fed reacted to the crisis by hiking interest rates to arrest the outflow of funds from the banking system, as the public rushed to buy gold. Money supply fell by 35% over the four years. No direct action was taken to bolster the balance sheets of the banks, with the result that bank lending, and many banks, collapsed. Finally, in 1933, the Reconstruction Finance Corporation was authorised to purchase bank stocks. This move helped to begin to rebuild confidence.

The **Swedish banking crisis which broke in 1990** developed in the second half of the 1980s and resembled the current crisis in developing on the back of an economic boom stoked by years of easy credit. Although the government reaction was at first piecemeal, it soon became apparent that it was a systemic crisis, requiring dramatic and comprehensive action.

Radical action was taken: the government stepped in to guarantee all liabilities of the Swedish banks, thus preventing a run on the banks. It established a Bank Support Authority, which helped banks rebuild capital reserves and allowed poor quality assets to be sold to two government agencies, "Securum" and "Retriva". The price extracted from the banks for this support was to give the government an equity stake. In the event, some banks were allowed to run down, and others were nationalised. The Swedish approach is considered to have been a success: early, decisive government action defused the crisis quickly, although the resulting recession was severe. The final cost to the taxpayer is estimated to have been less than 2% of annual GDP.

The "good bank" / "**bad bank**" approach had a number of advantages. It exploited differences of specialisation within the personnel of banks, between those better equipped to run a going concern, and those specialising in recoveries. Asset values were maximised, as the distressed assets were not liquidated, but managed by the state over a period of time. The siphoning out of the "bad" assets allowed the banks to return to "business-as-usual", and raise capital, more quickly, albeit on a more prudent basis than before.

There are important differences between this experience and the present crisis, which may limit its relevance today. Most important perhaps is the relative isolation of the problem within Swedish borders. The widespread nationalisation of the banking sector made the task of separating out and pricing the bad assets for sale to the public sector easier, and the financial products were less complex. Nonetheless, certain features of the approach appear to have ensured that the banking sector emerged stronger from the crisis, even if smaller, and essentially whole and commercially viable. The most interesting aspect of the approach was that a fresh start was made, on a basis of renewed confidence in the quality of assets on banks' balance sheets. Of course, bank lending to the private sector contracted for some years after the recession, reflecting the time lag between economic changes and lending.

The **Japanese crisis of the 1990s**, famously known as a "lost decade", was brewed by a phase of financial liberalisation and deregulation in the 1980s, accompanied by intense price competition, and an increased acceptance of risk among finance-providers, often associated with finance for industrial conglomerates linked to the banks. A series of economic stimulus packages were introduced over 8 years during the 1990s, which reached a total of Yen 124.4 trillion, much of which took the form of credit lines and cashable bonds. Both the easing of monetary policy and the fiscal injection were gradual. The slow policy reaction is widely considered to have been damaging for the economy and the financial system. Finally, however, in 2002 and 2003 vigorous action was taken. Until then, the banks had often allowed problem loans to continue festering, which meant that unviable businesses continued to burden the economy. Banks were forced to clean up their balance sheets in 2002 and to greatly restrict their equity holdings. Ultimately this had the desired effect, and the major banks returned to profitability in 2003. But the recovery cannot be wholly attributed to this policy; it was primarily thanks to the spill-over effect of the improving international economy.

The experience of Japan has influenced policy towards the current crisis, leading the authorities now to move quickly and in particular to intervene more actively in the banking sector, forcing troubled banks to take action to rebuild balance sheets and deal cleanly with problem assets.

It remains to be seen whether the more gradual approach will be judged to have caused less harm to the economy and society than the "short and sharp" approach. However, EMAC's economists judge that, for the banking sector, a more rapid recognition of problem assets (achievable in a number of ways) and retrenchment of business is likely to reduce the reputational and financial damage and thereby help to restore confidence, as well as economic activity, more quickly.

Shaping the future

The crisis has given rise to much soul-searching on the part of bankers, regulators and politicians. The financial world will have to change, but we cannot retrace our steps and return to a banking system of earlier, calmer decades. There is no possibility of return to the *status quo ante*, nor would this be desirable; thus the banking system has to evolve. According to Levine[4] (2004), market frictions motivate the emergence of financial systems that provide five broad categories of financial functions: (i) produce information *ex ante* about possible investments and allocate capital, (ii) monitor investments and exert corporate governance after providing finance, (iii) facilitate the trading, diversification, and management of risk, (iv) mobilise and pool savings, and (v) ease the exchange of goods and services. The provision of these functions may influence resource allocation and economic growth.

In contemplating policies and strategies for the future, there must be an understanding of the role of the banking and financial system, and the reality of the world in which it now operates. Although we are facing a unique crisis, requiring unique solutions, in the view of EMAC, a number of considerations need to be taken into account in framing policy:

[4] "Finance and Growth: Theory and Evidence", Ross Levine, 3 September 2004

1. Banking and finance are essential to the global economy and society, and lack of confidence in financial institutions is impeding economic activity. Government intervention was necessary in order to safeguard its citizens at a time of crisis. But public involvement in commercial activity should be kept to a minimum, and gradually withdrawn when the crisis is over and the framework of control has been suitably updated.
2. Past examples of crisis have shown that the final cost to government of the rescue package is likely to be lower than it appears at the time, when market values are at their lowest.
3. Public support for the economy at a time of crisis, implemented through intervention in parts of the commercial banking system, should be temporary. While it remains in place, banks should be encouraged to operate according to sound commercial banking practice, and should not be pressured to provide loans which prudent risk-assessment would not sanction. As shown by the Swedish example, effective public support makes it less likely that the strain on banks' balance sheets will lead them to deny credit to worthy candidates. As governments have taken control of some banks across Europe and the USA, the independence of national supervisors should be preserved and possibly strengthened.
4. Globalisation brings rewards as well as risks. But globalisation is not the cause of the crisis. On the contrary: lessons learnt from world economic crises 80 years ago teach us that economic renationalisation and growing protectionism exacerbate economic problems.
5. Banking sector consolidation must continue. As banks rationalise across functions and borders, the tendency to integrate institutions is likely to deepen. This should not cause disquiet, provided that there is sufficient international coordination built into the framework of control.
6. The traditional deposit-based banking structure will not, and should not, be the sole banking model. Investment banking will continue to play a valuable role. In recent years, banks have relied increasingly on non-deposit sources of funding, such as the capital markets and securitisation, which have helped to lower borrowing costs. The crisis is likely to make them more cautious in their reliance only on non-deposit sources in future. Nonetheless the deposit base will be insufficient to meet global financing needs in the years ahead. Banks' role in transforming maturities, via the capital markets, is indispensible to the economy, and this business must in future be conducted in a transparent and prudent way.
7. The reduction in leverage is likely to form a lasting effect of the crisis. The markets' perception of risk has been altered, and the authorities' steps to regulate and control the banking business will work against exuberance of the scale seen in the past decade.
8. The rebuilding of capital ratios must be done gradually, to avoid exaggerating the reduction in leverage, as noted recently by the IMF (Global Financial Stability Report update, 29 January

2009). As pointed out by ECB President Trichet[5], the markets are pressing banks to increase capital ratios to an inappropriate degree. The decision of the EU's Ecofin Council in October 2008 that confirmed the unchanged capital adequacy rules demonstrates that it, too, does not share the markets' view.

9. Innovation and originality in finance should not be suppressed. More sophisticated financial products and techniques should not be discredited; after all finance is a complex business. They should be employed in an environment of greater transparency, adequate supervision, and one where non-bank financial institutions are adequately accounted for. Financial innovation reduces capital market imperfections and helps make markets more complete. This opens up new possibilities to allocate capital across space, time and risk preferences. New financial instruments and practices, for example, allow firms to manage certain risks by shifting them to actors more willing to bear them.

10. Existing regulations need improvement. However, the impulse to resort to new and more stringent regulation must be tempered by an awareness of the risk of an excessive regulatory reaction. The widespread perception of an immense failure of regulators, supervisors and financial actors may lead to well-intended but poorly prepared regulations that will, in the best case, not address the roots of the problems. As has been seen in the past, this crisis has followed a period of innovation both in terms of products and rules (i.e. the introduction of Basel II, MiFID and IAS concurrently in Europe). When finance, and economies in general, flourish with a new momentum (which was the case in the post-WWII period[6]), the exceptional prosperity may also lead to a weakening in perception of risk. The natural reaction of policy-makers is to enter a phase of re-regulation, leading to a new bell-shaped economic growth, followed by a reversion to the previous pattern, with the likelihood of pro-cyclical regulatory measures. Lessons should be drawn from the weaknesses of the prevailing supervisory framework, and "mark-to-market" valuation principles, which have accentuated the current downturn. Greater transparency may be the most appropriate solution in some cases. In general: not more, but better regulation and application is the answer.

11. From now on, regulators and supervisors must be better able to understand the markets over the medium term, giving them the opportunity to identify earlier the development of "bubbles", or areas of excessive and uncontrolled exuberance.

Banks, among others, have learned a lesson from the crisis. In particular, it has been made clearer than ever that the essential underpinning for financial markets is confidence. This in turn depends on a degree of social endorsement of the objectives and methods of the financial sector. The consensus between the

[5] Davos World Economic Forum, 30 January 2009
[6] US Congressional Oversight Panel – Special report on Regulatory Reform, January 2009 (can be accessed here: http://cop.senate.gov/documents/cop-012909-report-regulatoryreform.pdf)

financial industry and society is now having to be rebuilt; along with the risk-awareness, controls and procedures which are fundamental for a sustainable banking business. The authorities, for their part, should be aware of the need to fashion measures, short and longer-term, with an awareness of the dynamics of the financial market.

If all sides play their part in rebuilding the financial structure, there is a good chance that it will be better able to adapt to the challenges of a multi-polar, increasingly integrated global economy in the future.

This edition of the EBF Letter is written by the Economic and Monetary Affairs Committee of the EBF (EMAC), which has the following members:

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