

Banks since the meltdown

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Abstract:

In general, economic and banking crises are triggered by the financing of unprofitable investments, which result in credit losses. The 2008 financial meltdown was no exception and, owing to its severity, governments and regulatory authorities had to recast the banking industry's regulatory framework. This involved higher prudential ratios, amended rules for the calculation of weighted risks and closer supervision. Crisis resolution arrangements were also overhauled with an eye to avoiding emergency interventions being paid from the public purse. There can be no doubt that the new environment is much more robust than before. Nevertheless, a number of questions remain. These include the potential ramifications of regulatory disparities between monetary areas on the effectiveness of financing economies and on the global allocation of savings flows. Other issues concern the overriding role of incumbent correlation models in risk measurement and the possibly pro-cyclical nature of accounting standards.

Banking and economic crises are closely intertwined and, in terms of causes and consequences, almost always leave credit losses in their wake. The latter are due to unfortunate financing choices for physical or financial investments which are unprofitable and for which the loans are unable to be repaid. Credit losses are part and parcel of business life and banks' operations. Crises occur when the extent of these losses means that they can no longer be absorbed in the normal course of business or when the way in which they manifest themselves sets off a sequence of distrust, economic recession and further losses. The 2008 financial crisis followed this template as it was triggered by losses on US subprime mortgage securities followed by distrust that was mainstreamed by poorly controlled dissemination of these assets in the global financial system and by the weakened liquidity of certain banks that had financed long-term illiquid assets with short-term liabilities to excess. There was an unprecedentedly rapid spread of distrust throughout the world which provoked a major economic recession which itself helped extend credit losses to many other types of assets. These included the debt of certain countries which is often well represented on banks' balance sheets.

Over the last decade, banks have been fighting for survival in the face of this distrust and actual or potential losses. They have also had to make substantial efforts to adjust to the new regulatory landscape following the crisis. The world's banks have experienced very different fates over the last ten years and the post-crisis model has shifted even if the basis of the profession is still the same. The impact of these changes on the financing of the economy, on the strengths and weaknesses of countries' banking sectors and on capital allocation between the different monetary areas, is still uncertain.

The confidence of depositors and other creditors is the lifeblood of banks and, between 2008 and 2011, in a climate of broad distrust towards the financial system, all banks had to constantly provide proof of their robustness, both in terms of capital and liquidity. It is common knowledge that liquidity only goes towards those who do not need it immediately. The defence measures are straightforward: transparent and credible financial reporting on balance sheets, bolstering equity by capital increases and subordinated debt issuance, and lengthening liabilities. Governments greatly contributed to restoring confidence by helping the most vulnerable banks either through general support measures (such as financing from the Corporation for Government Equity Holdings (SPPE) in France), or urgently to forestall the risks of contagion, by compulsory consolidation, guarantees or nationalisation (Northern Rock, RBS, ING, Fannie Mae, AIG, Dexia, CIF, etc.). There were very differing outcomes for the various institutions during this period: disappearance by takeover or liquidation (Lehman Brothers, Merrill Lynch, Deutsche Postbank, HBOS, etc.), strengthening through acquisition (Bank of America, BNP Paribas), long-term weakening or, conversely, strong recovery. In any case, ultimately, joint efforts from governments, supervisors and the banks broke the cycle of distrust. More importantly, the cycle halted itself when all the stakeholders were convinced that the credit losses had been definitively identified and transparently distributed between shareholders, creditors, taxpayers and clients. Crises are always exacerbated by uncertainty over losses.

Concurrent with these emergency initiatives and drawing on lessons learned from the crisis, governments and supervisors committed to a programme to overhaul the prudential framework for the banking sector at global, regional and national levels. Banks had to take these changes on board and this task remains uncompleted. The programme's goal is to mitigate the severity of future crises by making banks more robust (especially in terms of their ability to absorb losses which will obviously continue to be made) and by rolling out measures to better control the knock-on effects and distrust which are inherent to financial crises. This programme contains six main measures:

- Strengthening balance sheets through heightened requirements on capital and liquidity ratios
- A more conservative calculation of weighted risks, in particular market risks, the introduction of an unweighted leverage ratio to cover poorly identified or badly measured risks, and capping equity savings made possible by using internal models instead of standard models

- Closer supervision and stepped up verification of how banks measure their risks. For instance, for banks in the euro area which are overseen by the European Central Bank's Single Supervisory Mechanism: Asset Quality Review (AQR), Targeted Review of Internal Models (TRIM), annual Supervisory Review and Evaluation Process (SREP).
- Bans on certain activities for certain banks (Vickers and Volker rules or bank separation legislation in some European countries)
- A more forward-looking view of banks' ability to resist external shocks: stress tests, survival periods
- New resolution mechanisms to cushion the impact of a bank failure and, in particular, to mitigate the repercussions for government budgets: bail in, internal plans for the orderly winding up of banks, Single Resolution Mechanism in the euro area, greater powers for supervisors. These mechanisms have been used to good effect in Cyprus, Latvia and Spain.

The programme also led to the elimination of two fallacies that carried huge risks for the financial sector and which significantly contributed to the increased risk-taking by banks prior to 2008. These were the assumption that government debts were risk-free assets and the belief that financial markets were always able to provide almost infinite liquidity on all types of assets. Taking account of the risks attached to government debt and to haircuts for the "liquid" assets of banks removes the systemic relationship between sovereign risks and banking risks. It has also made the private banking sector more accountable for its risks by severely limiting the benefits deriving from the moral hazard.

Although a number of crucial issues are still under discussion (for instance, the CRR 2 and the harmonisation of the European deposit guarantee scheme), the banking sector seems to now have a broadly stable prudential framework which is much more robust than the previous version. In addition, banks are more solid, better controlled and are equipped with much more effective tools to handle crises.

Over the last decade, banks have also had to adjust to other changes in their environment: very low interest rates which undermine their profit-making capacity, regulatory reform affecting their market operations and sales of financial products (including the MiFID II in Europe), and significantly heightened requirements from the authorities in terms of fighting financial crime. This battery of changes has caused a huge increase in banks' production costs (levels of capital and liquidity reserves, cost of negative interest rates on liquidity reserves in the euro area, mandatory contribution to the Deposit and Resolution Guarantee Fund (FGDR), operating expenses generated by the new constraints). Clearly the impact of quantitative easing and low interest rates on the economic recovery, on the increased value of certain assets on banks' balance sheets and on the decline in the cost of risks has offset a substantial proportion of these higher costs. However, overall, banks have witnessed falling profitability especially in Europe, less so in the United States, and almost not at all in China. The expected levels of profitability required by investors before they provide the banking sector with the capital it needs for its future development are not yet known. Nevertheless, it can be assumed that they will settle for lower profitability than in the pre-crisis years in

order to have a more certain business model and due to the current interest rate levels, but this has yet to be established.

The last decade has witnessed a dramatic shift in the context in which banks operate. There is no doubt as to the expected benefits of these changes but, by way of conclusion, attention should be drawn to the fact that they also, and inevitably, raise fresh issues:

- Although much effort has been made to standardise regulations between the various geographical areas, there are still gaps - the impact of which will need to be gauged over time - which could widen (revision of the Dodd-Frank Act, Brexit).
- The increased cost of bank intermediation and more in-depth analysis of counterparty risks are gradually altering the structure of the financing of the economy. The trend is leaning more towards capital markets and an increase in capital requirements to fund the highest risks or those that are harder to measure (for instance, innovation and setting up businesses). This is clearly a step forward for the overall effectiveness of the allocation of savings for investments but it could cause transition difficulties in countries whose capital markets are under-developed or where, historically, less savings have been allocated to businesses' equity.
- Bank disintermediation alters the transfer of risks to investors and this can lead to sub-optimal risk pricing or undermine the stability of financing circuits, without going as far as shadow banking. However, the systemic impact of the credit losses that would have to be assumed by these investors will still be less than bank failures and their consequences on deposits.
- Today, the majority of risk calculations are based on historical models. It is not certain how they will stand up to the new economic paradigms.
- Lastly, accounting standards attempt to provide a snapshot of the value of assets on banks' balance sheets that is as close as possible to market realities. This means that credit risk provision methods are probably more pro-cyclical than in the past, even if their accompanying capital levels and buffers should enable this volatility to be absorbed.