Reforming the global and European financial sectors

Have the lessons of the last crisis been correctly learned?

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Warsaw **18-19, November, 2011**

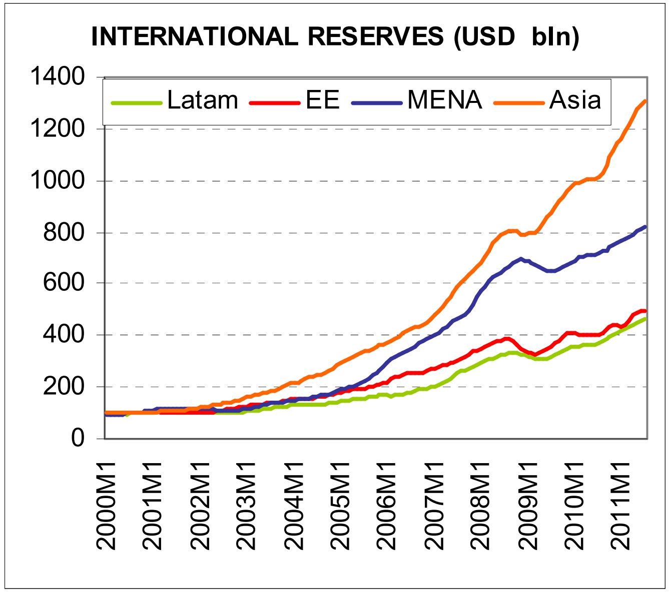
REGULATORY FAILURES CONTRIBUTED TO THE CRISIS

The world has become disillusioned from the laissez-faire ideology and self-regulating markets

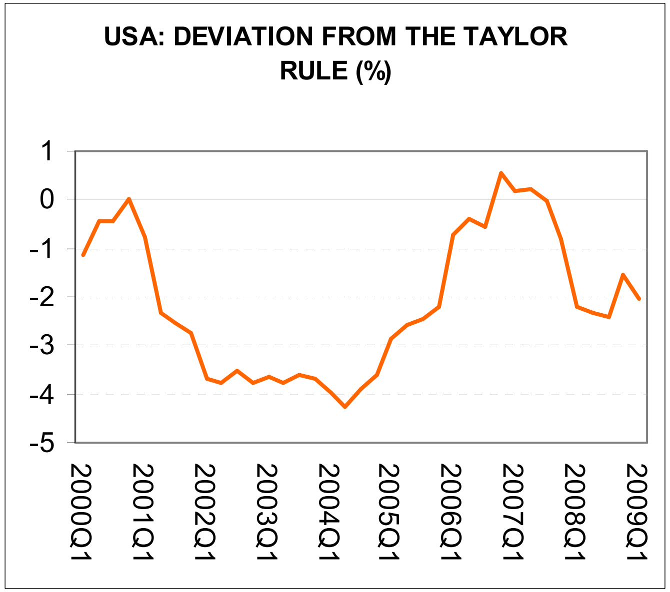
The crisis -at least partly- stemmed from regulatory deficiencies, hence stricter rules regarding the capital and liquidity position of the banks as well as strengthening the counter-cyclical nature of the rules are welcome

It must be noted, however, that the crisis has its roots in bad macro policies as well

- Loose monetary and fiscal policies
- Global imbalances
- Ample liquidity
- Perverse income distribution



Source: IMF



A SUMMARY OF NEW REGULATIONS

Basel II.5 describes changes to the **market-risk framework**

Basel III introduces new **capital target ratios,** rules for **capital quality ,** a **leverage ratio, liquidity coverage ratio (LCR), net stable funding ratio (NSFR), changes in counterparty credit risk (CCR)**

Dodd-Frank introduces expanded regulatory oversight of financial firms; new operating restrictions on some financial activities (including proprietary trading); increased mandates for firm governance; higher prudential regulatory standards; greater firm contributions to regulatory costs.

The European Commission's **European Market Infrastructure Regulation (EMIR)**.

Capital Requirements Directive 2 (CRD2),

Several countries have introduced **bank levies**.

New **compensation rules** are presented in CRD3

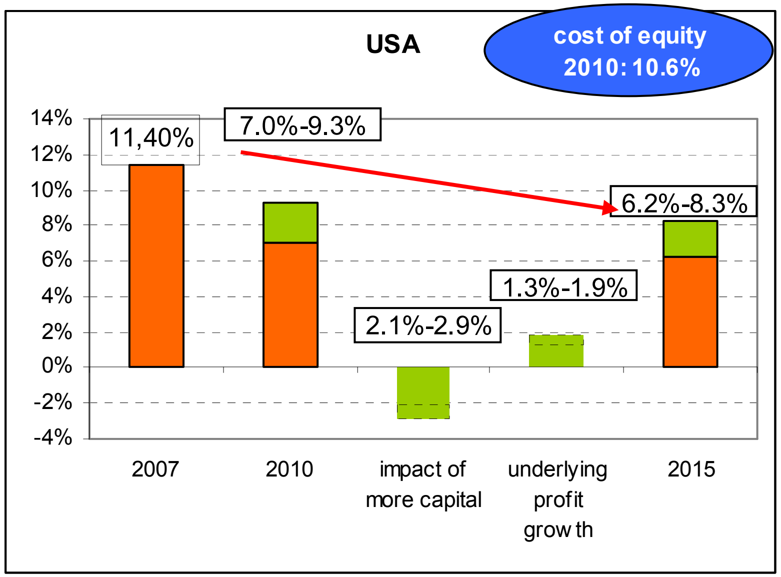
Capital surcharges for SIFIs.

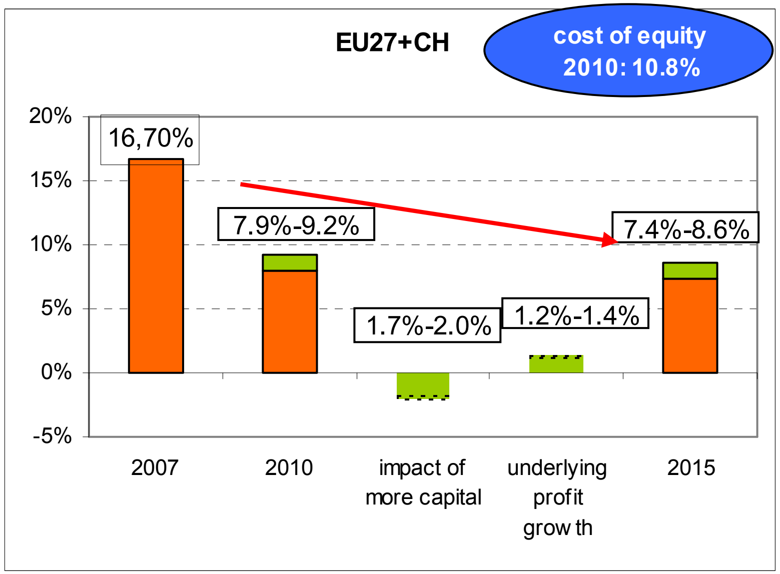
Ring-fencing etc.

BASEL III: THE IMPACT ON BANKS' PROFITABILITY

•higher required (core) tier 1 ratio
•stricter rules on (core) tier 1 capital definition
•more restrictive weights to calculate risk-weighted assets
•additional equity surcharges (1-2.5%) for SIFIs
•new regulations on LCR and NSFR result in additional funding requirements, higher funding costs

ROE FORECASTS FOR US AND EUROPEAN BANKING





Source: McKinsey, 2011
The higher numbers in the presented ranges represent ROE assuming loan losses near to the 2000-2007 average

REGULATORY REFORMS: THE MACROECONOMIC IMPLICATIONS

The question should be raised:

What the macroeconomic implications might be
if

We apply stricter rules on banks and at the same time

Carry out fiscal adjustment

Carry out external adjustment

These policies must be coordinated or they could easily prove to be counterproductive

A SUMMARY OF EUROPEAN BANK LEVIES

	TAX BASE	THRESHOLD	RATES	CAP	DEDUCTIBLE FOR CORPORATE TAX
Austria	Unconsolidated balance sheet total+ tax levied on the transaction volume derived from derivatives	Tax base of EUR 1bln	Progressive: between 1-20 bln: 0.055%, above 21 bln: 0.065%	N/A	YES
Cyprus	Total amount of deposits		0.095%	will not exceed 20% of the taxable profits	NO
France	Minimal amount of own funds required to comply with the coverege ratio's obligation	EUR 500 mln	0.25%	N/A	YES
Germany	Relevant liabilities	none	Progressive rates: between 0-10 bln: 0.02%, 10-100 bln: 0.03%, above 100 bln: 0.04%, plus 0.00015% for off balance sheet derivatives	15% of the annual net income	NO
Hungary	The adjusted balance sheet total From 2011, profitable credit institutions could be subject to a newly introduced profit-based surtax	none	Progressive rates: up to 50 bn = 0.15% above HUF 50 bn = 0.53%	N/A	YES, but not for the profit based part
Iceland	Total liabilities	none	0.000975%	N/A	NO

Source: KPMG

A SUMMARY OF EUROPEAN BANK LEVIES

	TAX BASE	THRESHOLD	RATES	CAP	DEDUCTIBLE FOR CORPORATE TAX
Portugal	Total liabilities and notional amounts of financial derivatives	none	Total liabilities: 0.05%; Financial derivatives: 0.00015%.	N/A	NO
Romania	Total liabilities	none	0.1285%	NO	YES
Slovakia	Total liabilities less the amount of equity	none	0.4% of the tax base	NO	TO BE CLEARED
Slovenia	Total assets	none	0.1% of the tax base	0.167% of the balance of loans given to non-financial corporations and sole entrepreneurs	NOT KNOWN YET
Sweden	Relevant liabilities - in general total worldwide debts and provisions	none	0.036% but a 50% reduced rate for 2009 and 2010.	N/A	POSSIBLY
UK	Relevant liabilities; 50% tax rate for “stickier” funding (>1 year maturity)	GBP£20 billion “relevant” liabilities	0.075% and 0.0375% for longer maturity funding in practice ; 2012 rates to increase to 0.078% and 0.039%.	N/A	NO
US	not yet determined, a prior proposal set it as the consolidated RWA	USD 50 bln for worldwide consolidated assets	not yet determined, a prior proposal set the rate at 0.075% of RWA	N/A	YES

Source: KPMG

THE TBTF PROBLEM

“If some banks are thought to be too big to fail, then … they are too big…
Mervyn King (June 2009)

“If the crisis has a single lesson, it is that the too big to fail problem must be solved.”
Ben Bernanke (2010)

Arguments against TBTF insitutions/SIFIs

- exacerbate systemic risk
- distort competition
- the treatment of TBTF institutions lowers public trust

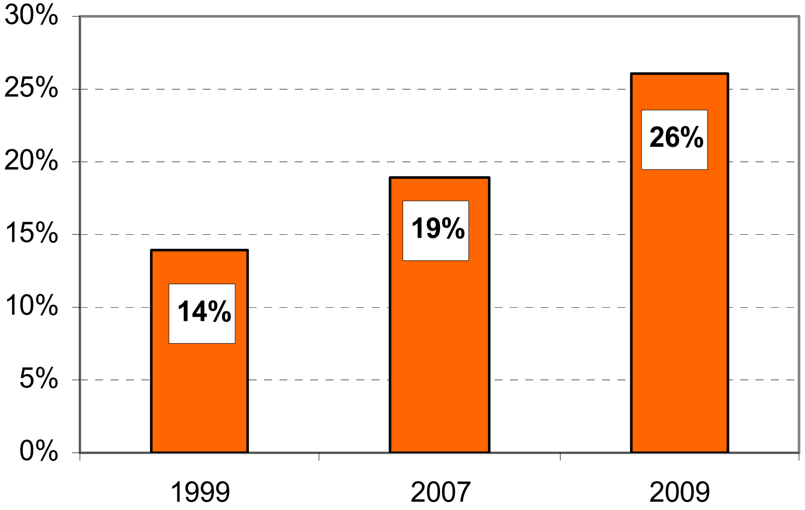
THE TBTF PROBLEM

M&A activity in the banking sector necessarily resulted in banking giants

The size of the banking sector relative to the economy –especially in Europe- in some cases reached absurd levels

But regulation targeted individual bank risks and did not address systemic risks

THE SHARE OF THE 10 LARGEST GLOBAL BANKS (in the assets of the largest 1000)



Source: IFSL, 2010

COMBINED ASSETS OF THE FIVE LARGEST BANKS RELATIVE TO GDP (%)

	1990	2006	2009
USA	11	45	58
Japan	59	96	115
Italy	44	127	138
Austria	N/A	135	141
Germany	55	161	151
Spain	66	179	220
Belgium	N/A	298	264
France	95	277	344
Sweden	120	312	409
Switzerland*	N/A	263	440
Netherlands	159	594	464
UK	87	301	466

Source: BIS, ECB, SNB

**2009: CR2 (2008 CR2: 620)*

REGULATORY EFFORST TO ADDRESS THE TBTF PROBLEM

THE TBTF ISSUE

The problem of „bigness”

Defining „bigness” ?

•<u>Curbing the size:</u>
Capital and liquidity surcharges
Competition policy
Size-related taxes, levies

•<u>Prohibit or cap them from growing beyond a size</u>

•<u>Breaking up too big institutions</u>

The problem of „failure”

•Special resolution regimes and authorities

•Orderly resolution plans (living wills)

•Making Creditors Pay: (contingent capital and bail-ins)

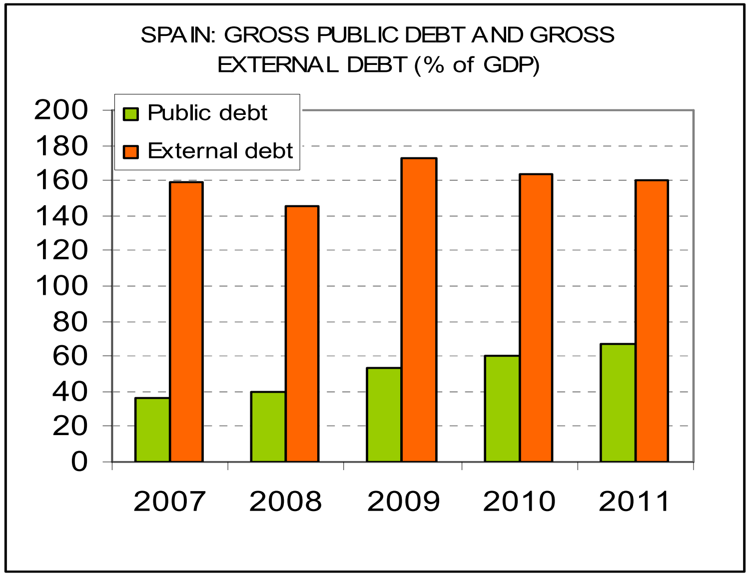
The TBTF problem is far from being solved, but recent legislations take into account some of the lessons we learnt from the crisis

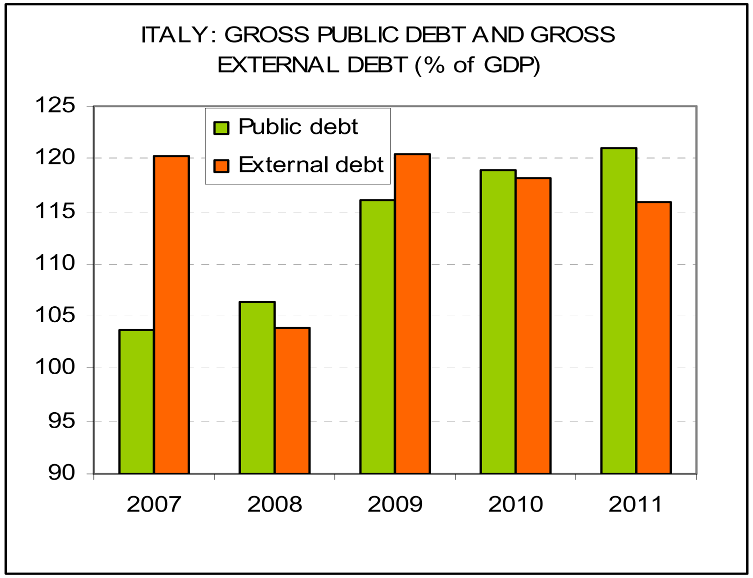
The EUR is a money without a state

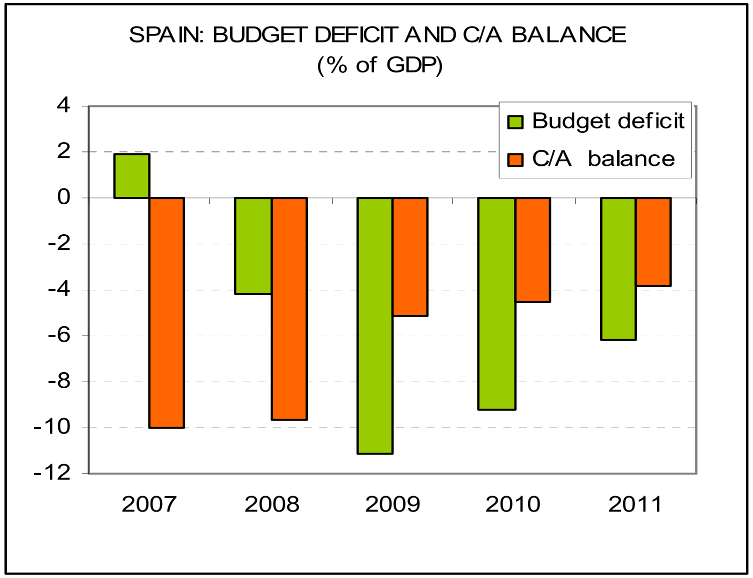
„You don’t know who to call when you want to telephone Europe”
(Henry Kissinger)

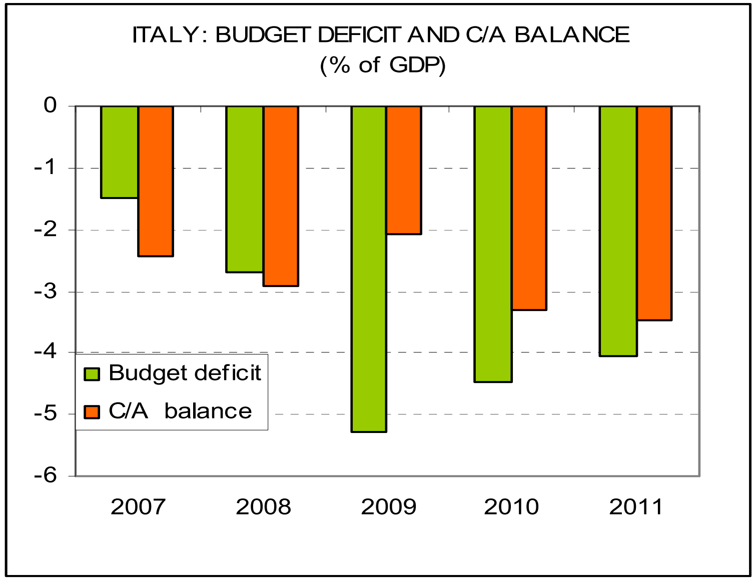
"We all know what to do, but we don't know how to get re-elected once we have done it".
(Jean-Claude Juncker)

THE EUROPEAN CRISIS



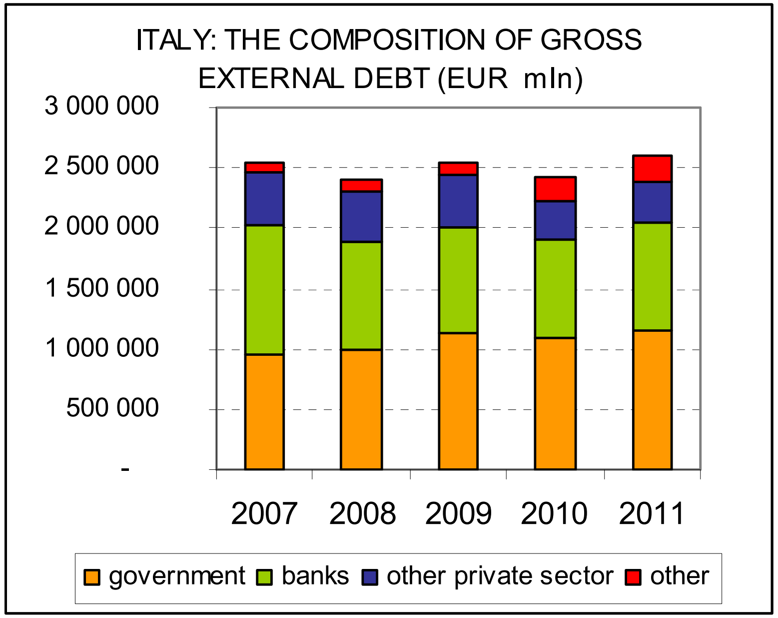


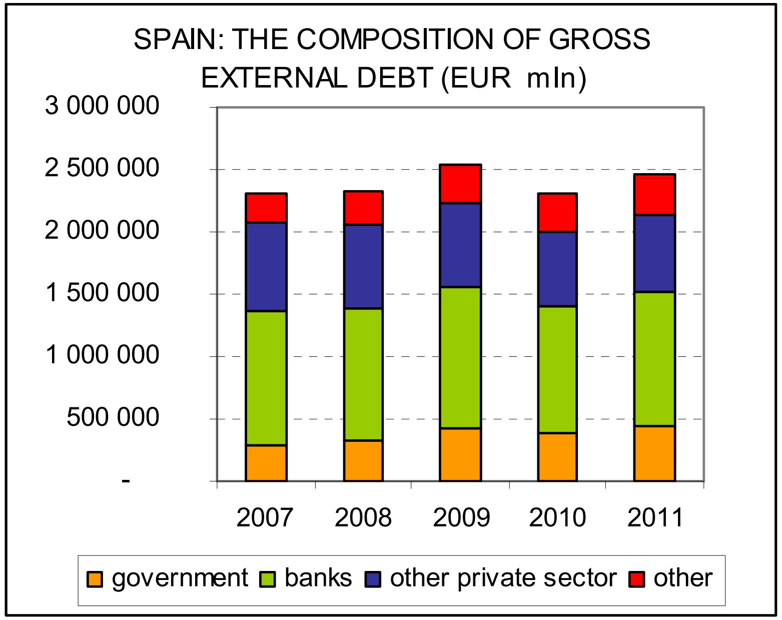




Source: IMF

THE EUROPEAN CRISIS: EXTERNAL POSITION MATTERS





Source: IMF

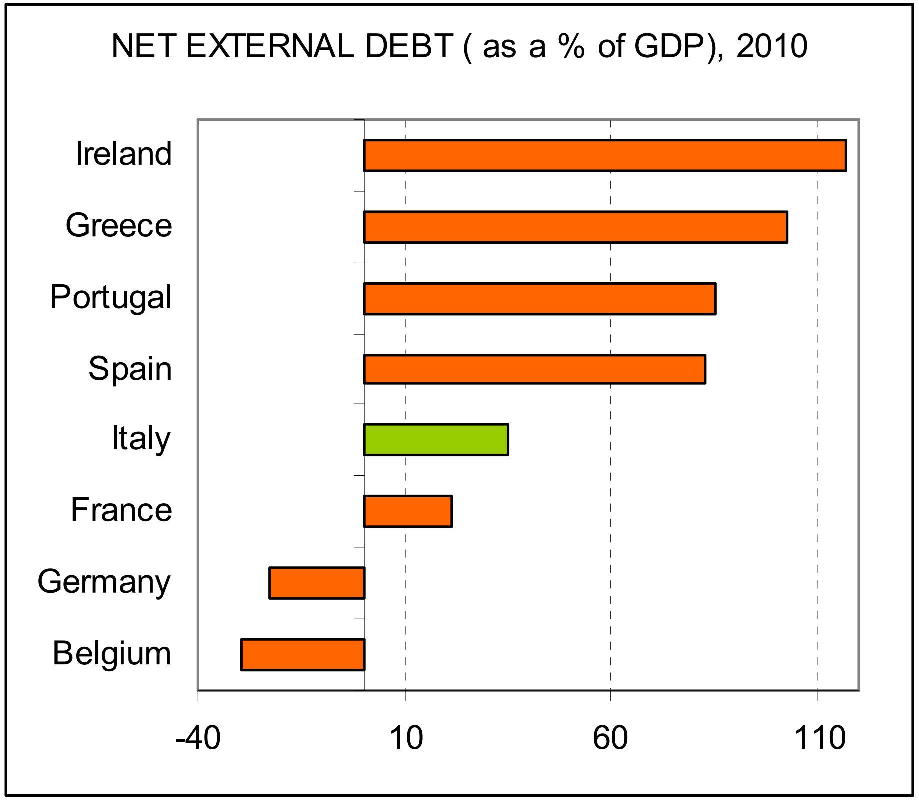
Rules that govern the EU and the euro zone still put too much emphasis on the fiscal position (deficit and debt)

The real barrier is the external position
(gross and net external debt, S-I position)

Italy: political crisis, growth crisis, structural problems

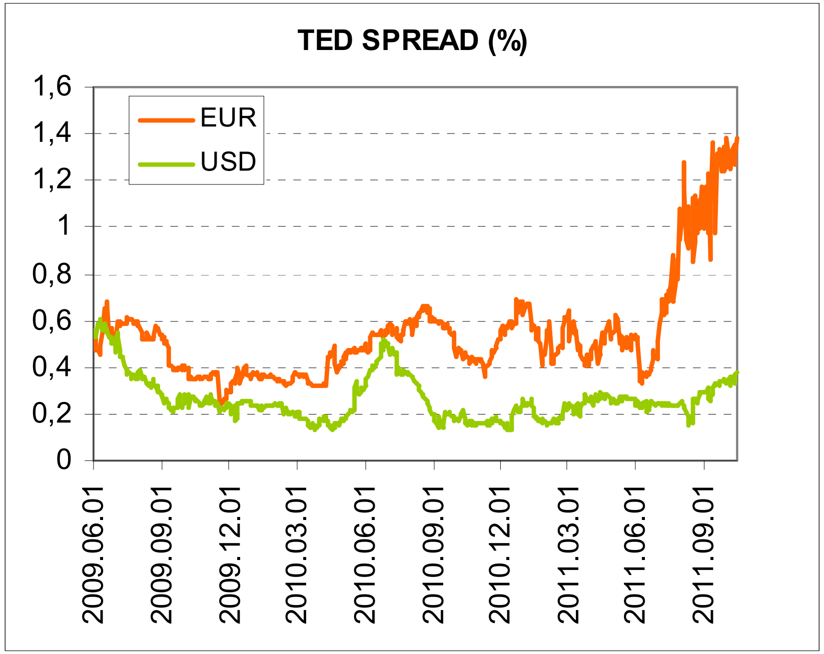
Spain: a relatively stable public debt position, but high level of gross external debt

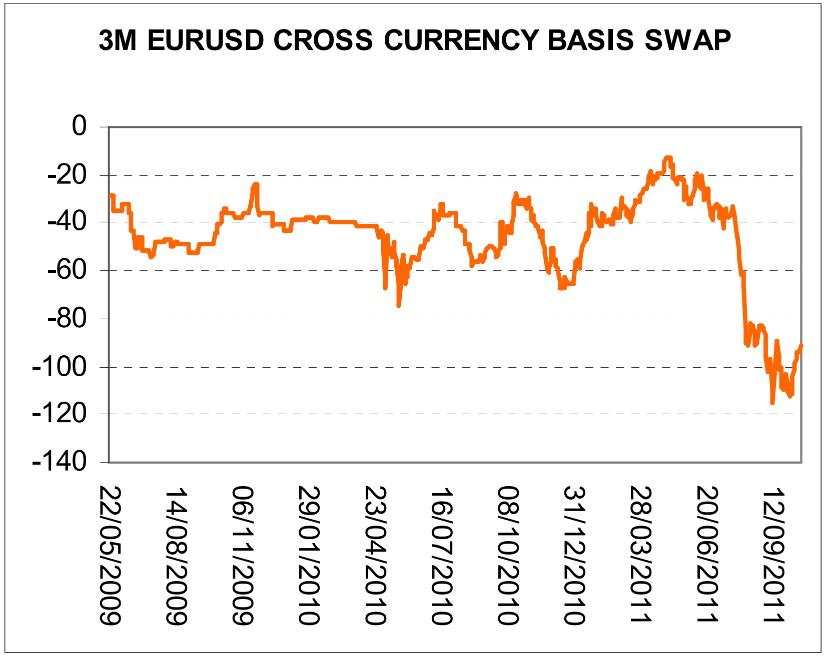
THE EUROPEAN CRISIS: EXTERNAL POSITION MATTERS



Source: IMF, National Central Banks

THE EUROPEAN CRISIS: A CRISIS OF CONFIDENCE





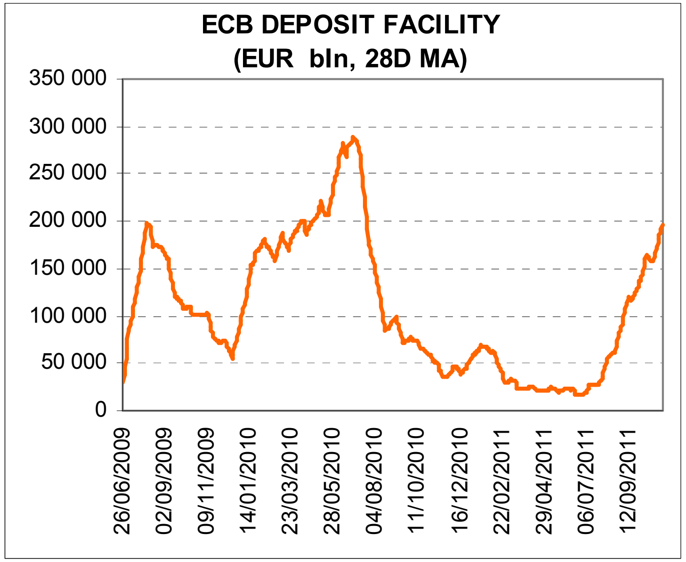
Source: Reuters, Bloomberg

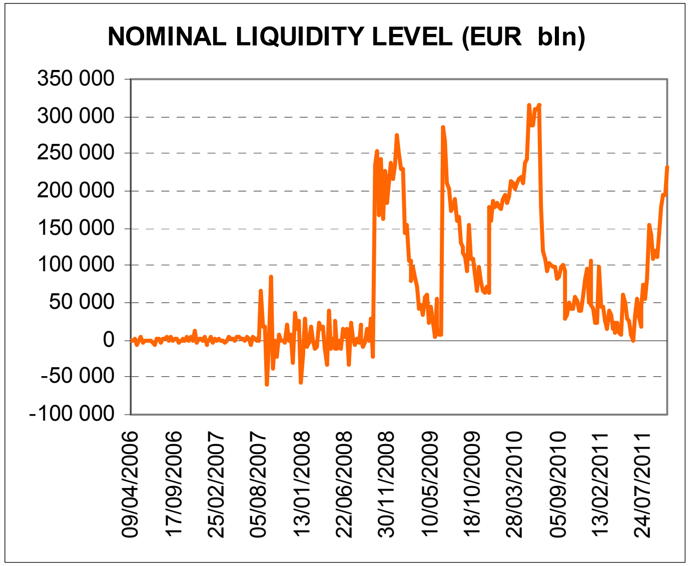
Inter-bank lending rates increased, particularly for dollar loans

Money market funds have reduced their dollar loans to European institutions

Funding pressures increased significantly amongst European banks

THE EUROPEAN CRISIS: A CRISIS OF CONFIDENCE





On the surface: The euro money market is oversupplied with liquidity Source: ECB

De facto there is a liquidity squeeze

Banking sector tensions continue to outweigh the ECB's support measures

(emergency borrowing from the ECB has remained elevated)

Interbank market: unsecured lending ⟷ ECB: provides liquidity against eligible collateral

The problem is the insufficient level of eligible collateral

The ECB is not able –due to its mandate- and not willing to fully compensate for the lower level of interbank liquidity

THE BLESSED TRINITY

- NO BAIL-OUT CLAUSE

- A SOVEREIGN BORROWER CAN NOT GO BUST

- ECB IS NOT A LENDER OF LAST RESORT

THE ROLE OF THE ECB

Heaping more responsibility on the European Central Bank to help solve the euro zone debt crisis would overburden it. To ask more of the ECB will challenge its independence.
(Juergen Stark)

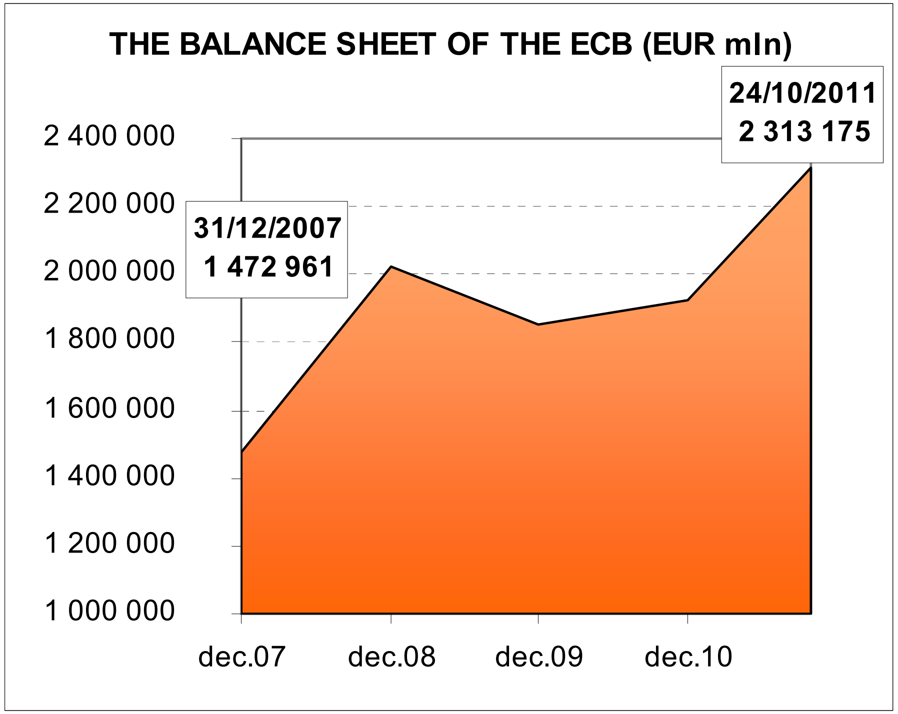
The bank had done "all it could" to fight the crisis.
(Jean-Claude Trichet)

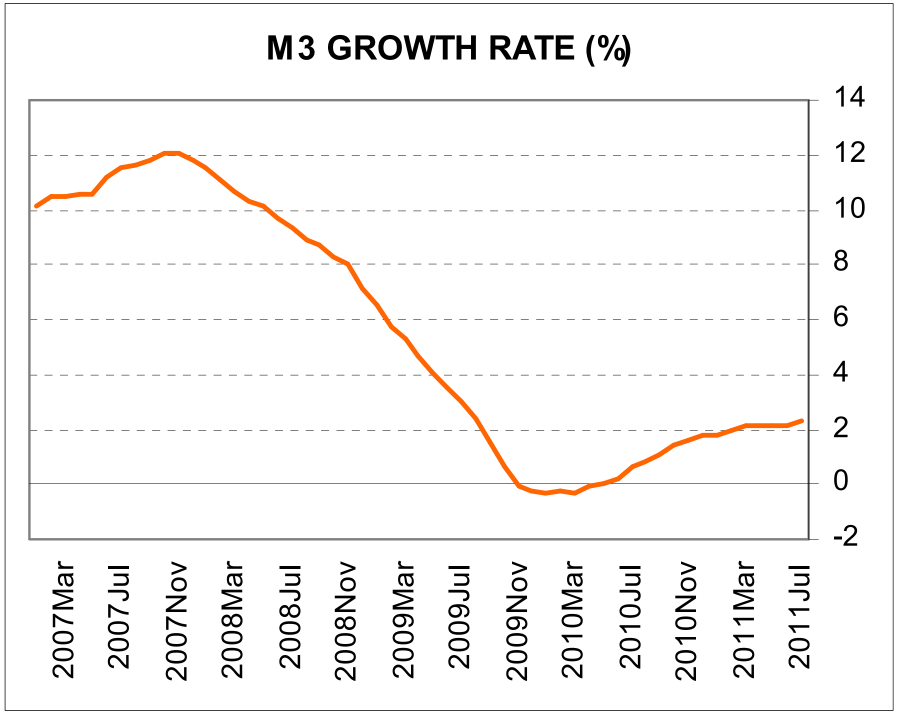
Literally it did all it could, but the actions were half-hearted and in some cases too little too late

Eurozone governments issue debt in a “foreign” currency, which they do not control by fiat.

If there is no lender of last resort, the sustainability of any system could be questioned (see also: the gold standard)

CREDITLESS RECOVERY?





Source: ECB

The behavior of the banking sector and the disfunctionality of the ECB could easily become a barrier to growth

CONCLUSIONS

In spite of all the efforts made so far European coordination does not work

Fundamental changes are needed in the governance of Europe

The rules that govern the EU must be changed:

Fiscal rules must be accompanied by rules regarding external stability (external balance, external indebtness)

Banking regulation: a Europe-wide, comprehensive solution is needed

Real cross-border banking is needed

The CEE region: if there is a liquidity crisis on core European markets, the CEE regions suffers disproportionately