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Financial Institutions Management 2

Financial crisis and the change of the banking business model

(ECB-1)

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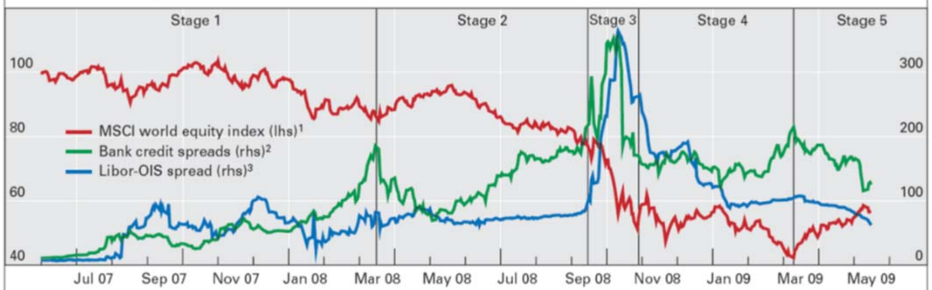
Outline

- Genesis and taxonomy of the crisis
- Any explanations available?
- Short term and long term measures provided by central banks and governments
- How to proceed and how to fix the financial system
- Forecasts for the future
- Long run perspectives
- The future of financial regulation

Chronology

The five stages of the crisis to date



[1] Morgan Stanley Capital International index, in US dollar terms; 1 June 2007 = 100. [2] Equally weighted average of CDS spreads (in basis points) for 18 major international banks; includes Lehman Brothers until 15 September 2008 and Merrill Lynch until 31 December 2008. [3] Three-month US dollar Libor minus overnight index swap (OIS) rates, in basis points.

Sources: Bloomberg; Markit; BIS calculations. Graph II.1

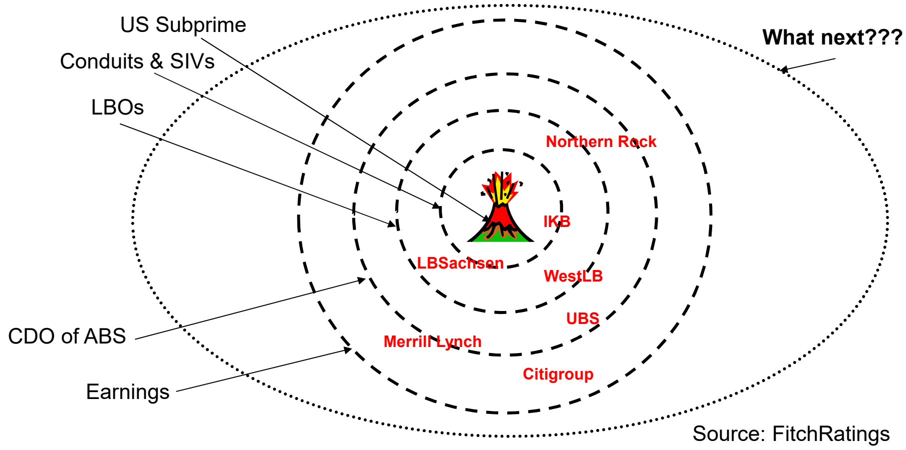
BIS, Annual Report, June 2009

The five stages of the crisis to date

- **Prelude to the crisis (Pre-March 2008):**
  - Subprime mortgage defaults and financial stress
  - Uncertainty about size and distribution of losses
- **Towards the Lehman bankruptcy (Mid-March to Mid-Sept. 2008):**
  - Bank losses and writedowns accumulate
  - Liquidity crisis reveals underlying solvency crisis
- **Global loss of confidence (15 Sept – Oct 2008):**
  - Demise of Lehman brothers triggers a bigger run on key funding markets
  - Loss of confidence affects markets and countries globaly
- **Global downturn (Late Oct 2008 – Mid-March 2009):**
  - Markets remain volatile, credit losses keep mounting
- **Downturn deepens but loses speed (since Mid-March 2009):**
  - Asset prices recover somewhat after more policy action
  - Confidence in the global financial system is not restored fully yet
  - Credit losses continue
- **Exit strategies**

The eruption of the crisis and the aftershock scenario

- Aftershocks at several levels detected



Source: FitchRatings

What happened in the centre?

- Collapse of the subprime mortgage system in the USA
- **Financial bubble(s) burst!**
- **"Originate and distribute"** model in the banking industry failed:
  - The traditional alternative **"originate and hold"** model
- Preconditions for the "originate and distribute" model:
  - Securitisation of financial assets
  - Easy access to debt / liquidity
  - Low cost of borrowing (i.e. low interest rates, attractive borrowing schemes)
- Different (segments of) financial markets higly interrelated and corelated

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Securitisation of mortgage loans

- **Securitisation:**
  = conversion of bank loans and other financial assets into tradable securities
- **Why is securitisation possible?**
- Credit fuction of banks can be split in several operations:
  - Origination of loans
  - Guaranteeing
  - Servicing
  - Funding
- **Why is securitisation useful?**
  - specialisation, liquidity, tailor made financial assets, risk profile …
- Securitisation of mortgage loans!

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Mortgage funding process (1)

- Mortgage funding process:
  - securitisation and issuance of mortgage backed securities: MBS
- Issuers:
  - Government Sponsored Agencies (GSA)
    - GNMA, FNMA, FHLMC
  - Private issuers (segment of subprime mortgage loans)
- Criteria for categorisation of MBSs:
  - Credit record and score
  - Debt service-to-income ratio (DTI)
  - Loan-to-value ratio (LTV)
- Categorisation of MBSs:
  - “Prime”
  - “Sub-prime”: low credit scores, DTI > 55%, LTV > 85%
  - “Alt-A” = alternative to prime loans; met criteria but missing documentation

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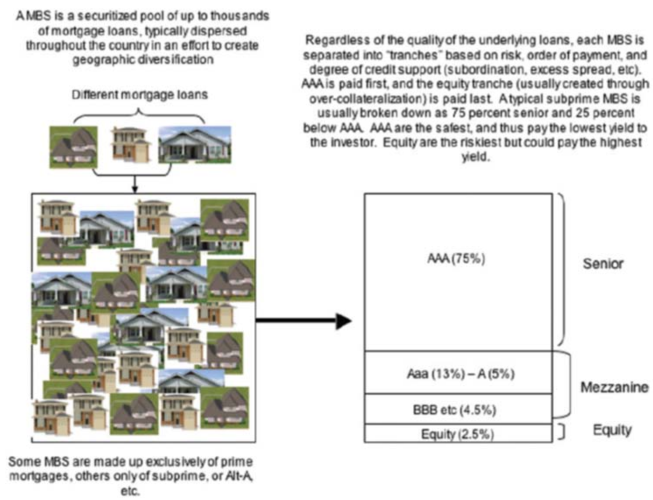
Mortgage funding process (2)



Source: Baily, Litan and Johnson, 2008

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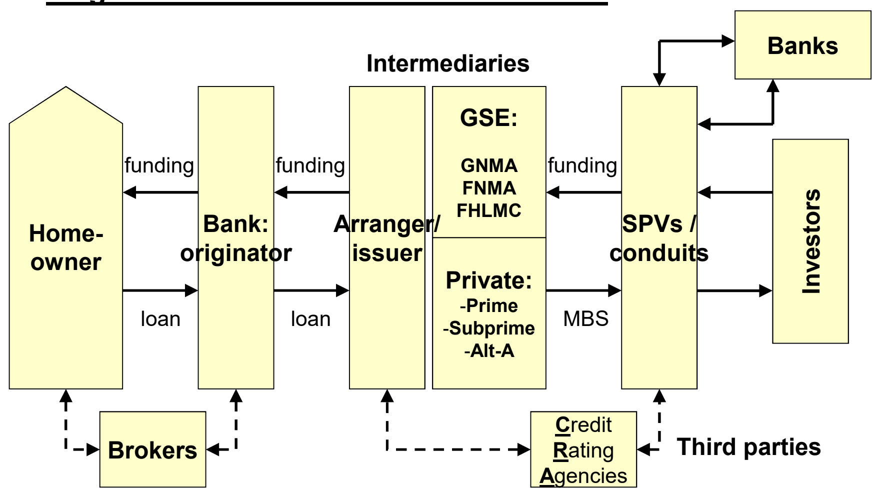
Subprime mortgage loans

- Subprime mortgage loans – some of the related issues:
  - "predatory lending"
    - Example:
      "Low doc" loans (less documentation required) evolved to "no docs" and to "liar loans" (borrowers were allowed and even encouraged to lie about income and other information relevant to the application process),
      "Ninja loans" (no income, no job, no assets).
  - "predatory borrowing":
    - A stated income loan application is done by the borrower, and no proof of income is needed
  - fixed-rate mortgages (FRM) vs. adjustable-rate mortgages (ARM)
  - "hybrids" and "teaser rates"
  - complicated products

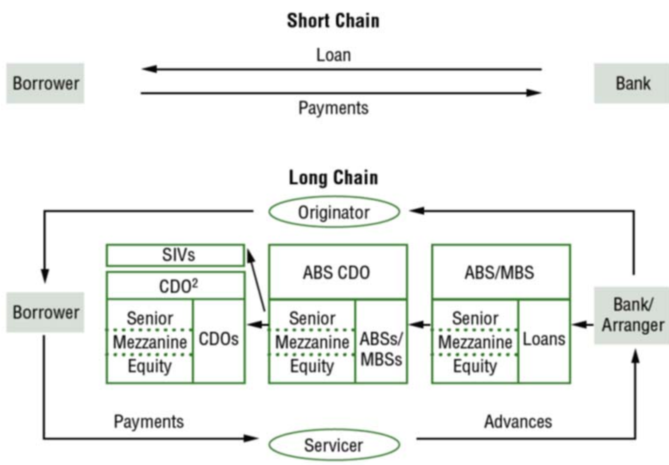
Securitisation of mortgage loans

- **Originate and distribute business model:**



Illustrative intermediation chain

- "Originate to hold" vs. "originate to distribute"



Source: IMF, GFSR 2009

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The crisis has spread around

- The immediate aftershocks:
  - ABCP (asset backed commercial papers)
  - SIVs (special investment vehicles)
  - LBO exposures
  - CDO (collateralized debt obligations) of ABS (asset backed securities)
  - Earnings in the financial industry (substantial writedowns!)
  - Monolines and insurance companies issuing CDSs (CDS = credit default swap)
- The second, third,…round aftershocks
  - Commercial banks, interbank market, equity markets, nonfinancial effects (decreasing sales,…), currency markets affected,…
- Globalisation of the crisis

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Direct causes at the origin

- **Direct causes:**
  - The way how mortgage loans were produced:
    - "*originate and distribute*" => carelessness of the originators /agents (moral hazard situation)
  - The securitisation process of the mortgage loans:
    - Kind of mortgages as well as process of refinancing (short term!)
      - So long as the house price was rising…
    - Structured products : "turning lead into gold"
      - $100 of sub prime mortgages into $70 to $80 of short maturity AAA securities
  - The role of CRAs (credit rating agencies):
    - Advisors and rating agents – all in one! (conflict of interests)
  - Regulation:
    - Some segments not regulated or "selfregulated"

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The circumstances

- **Elements of the crisis which had catalytical effects:**
  - High and excessiv leverage:
    - e.g. Lehman Brothers < 5%
  - Short term wholesale financing and tremendous maturity mismatch:
    - The most common type of debt: 3 m commercial papers
    - Excessive "funding" illiquidity => insolvency => panic
  - Low quality of the assets:
    - The quality of the assets turned out to be worse than expected
- **Lethal combination of all three effects (1, 2, 3):**
  - Some investment banks, SIVs / SPVs, conduits

"*As long as the music is playing, you've got to get up and dance*"
- Charles O. Prince, CitiGroup (FTimes)

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Fundamental causes of the crisis

- "*This crisis has many causes – not just private sector stupidity and greed*"
  – P. Mortimer-Lee (BNP Parisbas)
- **The most important are:**
  - Global imbalances
  - Conduct of the monetary policy in the major economies
  - Financial innovation and regulatory arbitrage:
    => change in the banking business model

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Fundamental causes: Global imbalances

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- **Global imbalances:**
  - Emerging market crises in late 1990s:
    - The global mismatch between desired savings and realized investment
    - Emerging markets and developing countries focus on exports, and generate substantial domestic savings
      =>Demand for high rated paper & => short maturities
  - Industrial countries (e.g. US) expand domestic demand:
    - But after collapse of "dot.com" bubble, corporate savings and subdued investment
    - Household savings falls, residential investment increases
  - Rise in asset prices (bubbles!):
    - Financed by rapidly growing emerging economies (e.g. Asia)
    - Assisted by national central banks and their monetary policies

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Fundamental causes: Monetary policies

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- **Monetary policies in developed economies:**
  - Historically low interest rates
  - Maintenance of high liquidity
  - External inflationary shocks (e.g. energy, food)
  - Pressure for higher returns => take more risk
  - Excessive demand => (financial) asset bubbles
  - The role of central banks:
    - Should they "lean" against the asset price / debt extension phenomenon? or
    - Should they just "clean up" after the event? – But, once you do it, everybody expects you will do it again!

Fundamental causes: Financial innovation (1)

- **Financial innovation and regulatory arbitrage:**
  - Traditionally "originate and keep" model in banking
    - Intensified regulation of the banking sector (e.g. capital charges) => regulatory arbitrage
      (e.g. morgage loans distributed via unregulated financial instruments to unregulated financial intermediaries
  - Development of the "shadow banking" system:
    - Conduits, SPVs, SIVs

"*Over time, however, many roles traditionally filled by banks were taken over by unregulated institutions – "shadow banking system", which relied on complex financial arrengements to bypass those safety regulations*"

- P. Krugman (2008)

Fundamental causes: Financial innovation (2)

- **Innovations in regulation:**
  - New capital adequacy standards in banking industry (i.e. Basel 2):
    - Does it work properly?
    - Example:
      - The UK FSA (Financial Stability Authority) allowed Northern Rock to calculate its capital on the basis of IRB
      - Reduction in capital followed and the bank paid a massive dividend to shareholders as a result
    - Procyclical effects
  - Implementation of the "mark-to-market" principle
    - Inadequate credit risk provisioning? => cyclicality in credit activity of banks

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Damage to the financial sector (1)

- Some 2009 figures… Banks
- Some GDP figures for comparisson:
  - Germany $3444 bn
  - UK $2440 bn
  - USA $14800 bn

Banks

-	Company	Total writedowns and credit losses since Jan 2007 ($bn)
1	Wachovia	95.5
2	Citigroup	67.2
3	Merrill Lynch	55.9
4	UBS	48.6
5	Washington Mutual	45.6
6	HSBC	33.1
7	Bank of America	27.4
8	National City	26.2
9	JPMorgan Chase	20.5
10	Lehman Brothers	16.2
11	Royal Bank of Scotland	15.8
12	Morgan Stanley	15.7
13	Bayerische Landesbank	14.8
14	Wells Fargo	14.6
15	IKB	14.4
16	Credit Suisse	14.2
	Worldwide	741.2

Source: Bloomberg, FT

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Damage to the financial sector (2)

- Some 2009 figures… Insurance companies
- Some GDP figures for comparisson:
  - Germany $3444 bn
  - UK $2440 bn
  - USA $14800 bn

Insurers

-	Company	Total writedowns and credit losses since Jan 2007 ($bn)
1	AIG	60.9
2	Ambac	10.6
3	Hartford Financial	7.9
4	Metlife	7.2
5	Allianz	4.5
6	Prudential Financial	4.4
7	Allstate Corp	4.4
8	MBIA	4.3
9	Swiss Re	4.2
10	Aegon	3.8
	Worldwide	146.0

GSEs

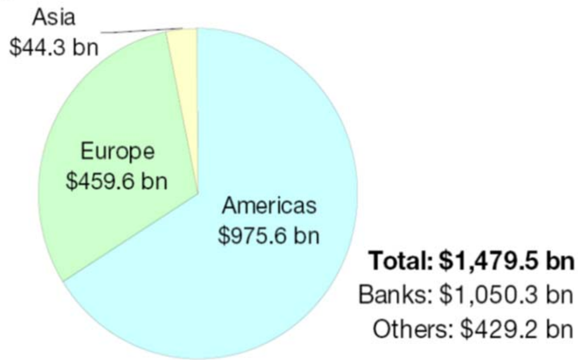
	Company	Total writedowns and credit losses since Jan 2007 ($bn)
1	Freddie Mac	58.4
2	Fannie Mae	56
	Total	114.4

Source: Bloomberg, FT

Damage to the financial sector (3)

- Geographical distribution of reported losses at FIs

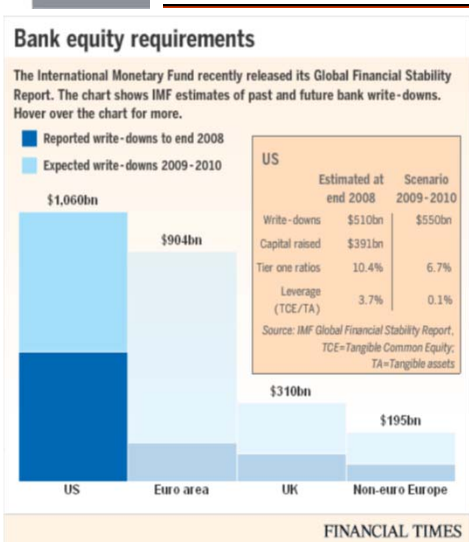
Reported Losses at Financial Institutions*

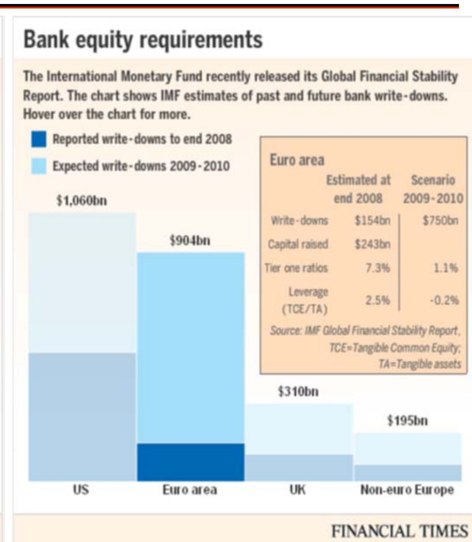


* Includes writedowns and credit losses for banks/brokers, insurance companies and U.S. mortgage-market GSEs. Losses since beginning of 2007.

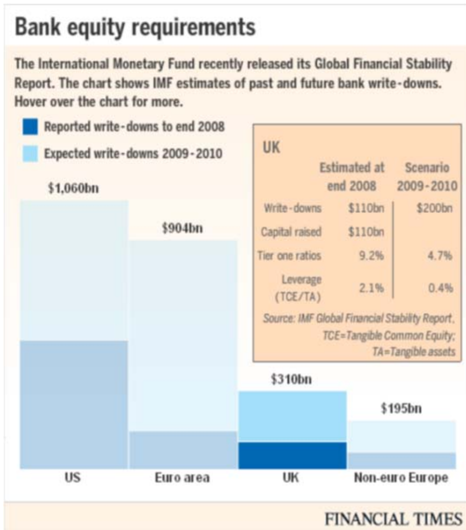
Source: IIF (June, 2009)

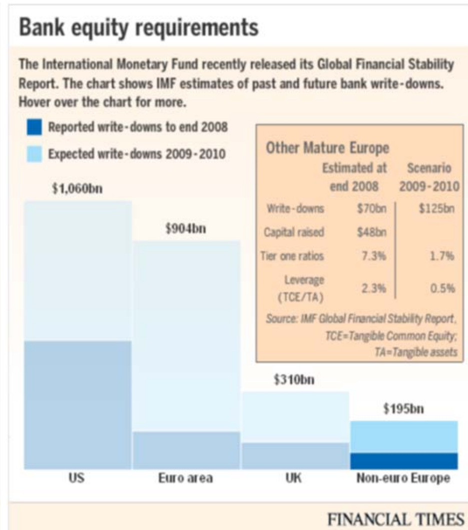
Damage to the financial sector (4)





Damage to the financial sector (5)





Damage to the financial sector (6)

- Consequences for bank stocks in course of the crisis

Source: IIF (2009)

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Unpleasant consequences

- **Consequences for financial markets:**
  - **<u>Illiquidity:</u>**
    - Illiquidity has spread from the relatively obscure sub-primer market to national markets and even globally
    - Debt markets, interbank markets affected
  - **<u>Loss of confidence & growing uncertainty</u>**
  - Substantially increased **<u>volatility of market rates</u>**:
    - Short term financial instruments affected the most
- **How to bridge these obstacles in the markets?**
  - Need for liquidity => central banks
  - Need for credibility => central banks / governments
  - Need for funding => governments

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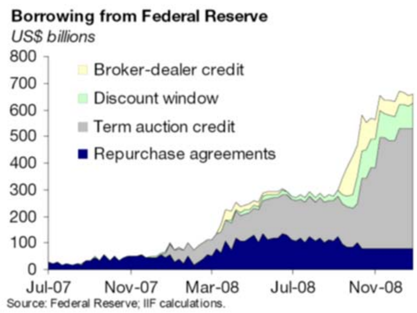
Immediate interventions (1)

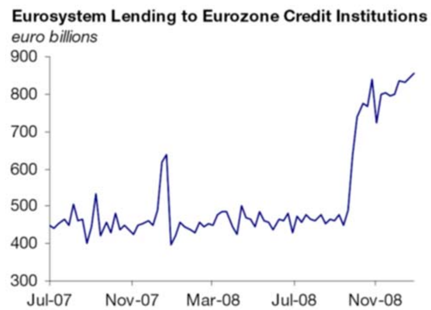
- **Central banks:**
  - Providing substantial amounts of extra liquidity
  - Lowering interest rates in order to impact market rates and stimulate borrowing and sending signal
  - But still a problem: market for interbank loans

"*There have been three great inventions since the beginning of time: fire, the wheel and central banking*." – Will Rogers

Immediate interventions (2)

- Central banks continue to pump liquidity into banking systems





Source: IIF (2009)

Asset Holdings of Major Central Banks Related to Monetary Policy 2008 - 2012

Table 3.1. Asset Holdings of Major Central Banks Related to MP-Plus, 2008–12

	Dec-08	Dec-09	Dec-10	Dec-11	Oct-12	Reasons
European Central Bank (in billions of euros)						
Short-term liquidity	226	81	249	160	117	Maintain sufficient bank intermediation
Long-term liquidity	617	669	298	704	1059	and provide longer-term bank financing
Asset purchases						
Covered bonds (CBPP)	...	29	61	62	70	Sustain key bank funding channel
Government bonds (SMP)	...	...	75	213	208	Maintain/restore European Central Bank policy rate transmission
Memorandum items: Total assets	2,043	1,852	2,004	2,736	3,047	
GDP	9,242	8,922	9,176	9,421	9,503	
Federal Reserve (in billions of U.S. dollars)						
Short-term liquidity						
Loans and repo	274[3]	86	45	9	1.2	Provide adequate short-term bank funding
U.S. dollar swaps	554	10	0.08	100	12.5	Provide adequate funding for foreign exchange operations
Long-term liquidity						Provide adequate long-term bank funding
TALF	. . .	0.30	0.67	0.81	0.86	against MBS and ABS collateral
Asset purchases						
Agency MBS	. . .	908	992	837	852	Support housing finance
Agency debt	20	160	147	104	82	Support GSEs
Treasury securities	476	777	1016	1672	1651	Affect level and shape of yield curve
Memorandum items: Total assets	2,241	2,237	2,423	2,928	2,832	
GDP	14,292	13,974	14,499	15,076	15,653	

Source: IMF, FSR Apr 2013

Asset Holdings of Major Central Banks Related to Monetary Policy 2008 - 2012

Table 3.1. Asset Holdings of Major Central Banks Related to MP-Plus, 2008–12

	Dec-08	Dec-09	Dec-10	Dec-11	Oct-12	Reasons
Bank of England (in billions of pounds)						
Liquidity (longer term)[1]	170	24	17	10	11	Provide adequate bank refinancing
Asset Purchase Facility						
Gilts	. . .	188	198	249	375	Raise nominal spending in order to meet inflation target by affecting level and shape of yield curve
Corporate bonds	. . .	1.55	1.12	0.65	0.03	Improve liquidity in corporate credit
Commercial paper	. . .	0.43	0.00	0.00	. . .	
Funding for lending	. . .	. . .	. . .	. . .	4.4[2]	Encourage lending to the real economy
Memorandum items: Total assets	238	238	247	290	414	
GDP	1,441	1,402	1,467	1,516	1,548	
Bank of Japan (in trillions of yen)						
Liquidity (new stimulus)	...	...	24.8	32.0	29.0	Ease financing conditions
Other outstanding loans and repo	39.9	42.3	18.8	7.5	3.7	
Asset purchases						
Commercial paper	...	...	0.1	2.0	1.5	Reduce market rates and risk premiums across various types of financial assets and combat deflation risks
Corporate bonds	...	...	0.1	1.5	2.9	
Government bonds and bills	...	...	1.2	5.6	28.4	
ETFs, REITs	...	...	0.02	0.9	1.6	
Memorandum items: Total assets	123	123	129	143	150	
Total sovereign holdings	63.1	72.0	76.7	90.2	107.6	
GDP	501	471	482	471	477	

Source: IMF, FSR Apr 2013

Immediate interventions (3)

- Government **rescue programmes** for national banking sectors, announced at the end of 2008:
  - Expansion of retail deposit insurance
  - Guarantee of wholesale liabilities
  - Capital injections
  - Asset purchases

  "*The important thing for government is not to do things which individuals are doing already, and do them a little better or a little worse, but to do those things which at present are not done at all*."
  – John Maynard Keynes

- State aid in the EU: http://ec.europa.eu/competition/elojade/isef/index.cfm?fuseaction=dsp_sa_by_date
- Governments need to **borrow extensively**:
  - Crowding out effect
  - Where do savings come from?

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Costs of government bail-outs

B. of A. 40b

AIG, 40bn

Citigroup 25bn+20bn

JP Morgan 25b
Morgan St. 10b

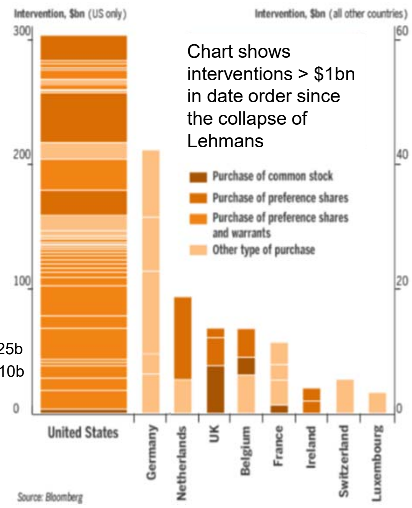

Chart shows interventions > $1bn in date order since the collapse of Lehmans

Each coloured block represents one government intervention at a bank

The area of each block represents the size of the intervention

Germany ($3444 bn):
- West LB, Jan 2009, $6.4 bn
- Commerzbank, Oct, $10.8 bn
- Bayer. Landesbank, Mar, $8.5 bn
- IKB, Feb 2008, 3.1 bn
- West LB, Jan 2008, $6.4 bn

UK ($2440 bn):
- Lloyds TSB, Oct 2008, $1.5 bn
- HBOS, Oct 2008, $4.5 bn
- RBS, Oct 2008, $7.5 bn

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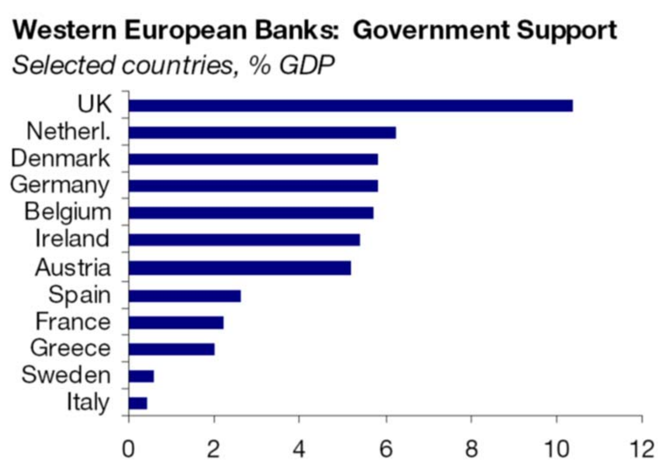
Governments' support to banks



IIF, June 2009

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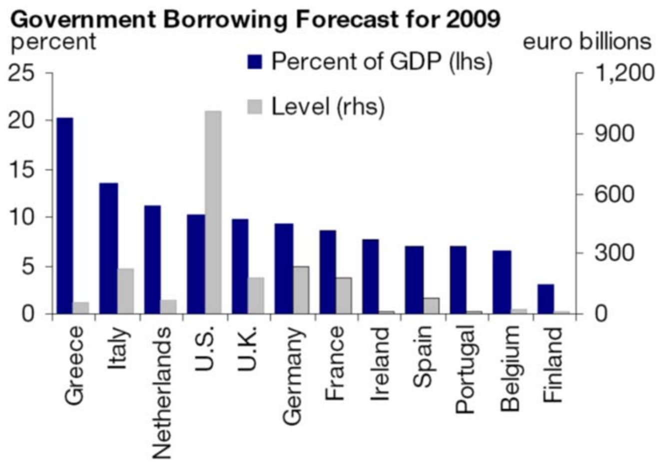
Government borrowing forecast for 2009

- Government borrowing forecast. Enough for all of them?



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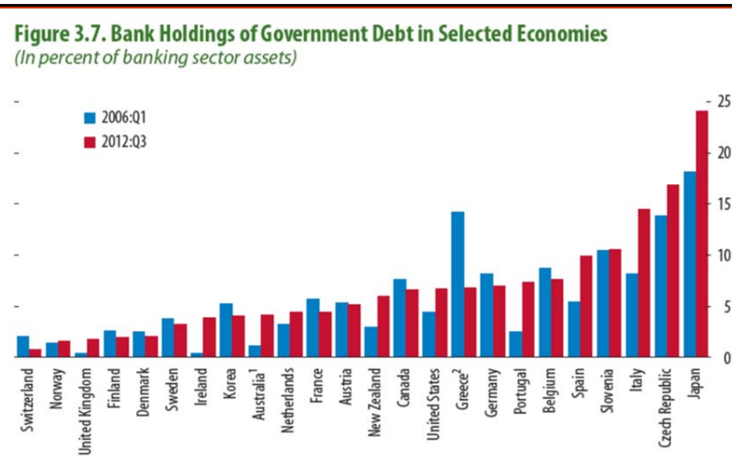
Bank Holdings of Government Debt in Selected Economies



IMF , FSR Apr 2013 Sources: Central banks' and national regulators' websites; IMF, *International Financial Statistics* (IFS); and IMF staff estimates.

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Coordination of interventions

- **Coordination among central banks ?**
- **Coordination among governments?**
  - To some extent within the EU (Oct. / Nov. 2008)
  - G20 Summits:
    - Washington Summit (Nov. 2008):
      - Bretton Woods 2 ? – Definitely not!
      - Great expectations about short term “fire fighting” measures and long term institutional reforms
      - Very modest results
    - London Summit, UK, April 2009.
    - Pittsburgh Summit, Pennsylvania - US, Sept. 2009:
      - More specific solutions
  - World Economic Forum in Davos (Jan 2009)

Long run perspectives

- Immediate “fire fighting” measures not enough! - Institutional reforms needed!
- Some of the issues that need to be addressed:
  - Different approaches in regulation and supervision of financial markets and institutions:
    - Do we need to regulate everything ?
    - The operating mode of regulators and supervisors (single vs. multiple regulators)
    - Can regulation slow down financial innovations ?
    - How will pay the cost of more regulation ?
  - Risk management in financial and non-financial firms
  - Some accounting practices (e.g. mark to market)
  - The role of CRAs. Do they need supervision?

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The new shape of regulation

(FT, 22. June 2009)

	Systemic risk	Bank capital	Consumer protection	OTC derivatives	Hedge funds
US	The Federal Reserve would be charged with monitoring large interconnected financial companies to ensure that they are not putting the entire system in danger through their own unsafe balance sheets. The work would be complemented by a new oversight board.	Raising capital requirements is an important pillar of US - and one that can be accomplished without Congress. All financial institutions will have to hold more capital and use less leverage; the most systemically significant will have to hold the most. The administration is also committed to tightening the rules internationally through changes to the Basel accords.	The Obama administration has proposed creation of a Consumer Financial Protection Agency to protect consumer purchasers of all financial products and services not already regulated by the SEC, including mortgages, credit cards and insurance annuities. It would set standards for intermediaries, such as mortgage brokers, and protect consumers from abuse and deception.	Congress is writing legistation that would require "standardised" OTC derivatives to be processed through clearing houses, which step in when a party to a trade defaults. Although some OTC derivatives are already cleared, many other types - including those blamed for exacerbating the financial crisis - are not, exposing the financial system to potentially huge risks in the event of defaults.	The Obama administration has proposed requiring all managers of hedge funds to register with the Securities and Exchange Commission. They would be subject to new record keeping and disclosure requirements and the SEC would be permitted to conduct regular periodic examinations to monitor compliance. (Needs Congressional approval)
EU	The European Commission is considering the creation of a systemic risk council to assess and warn of threats to financial stability in the region, and a new system of financial supervisors which will oversee individual banks and financial firms. On the latter front, three existing pan-EU co-ordinating committees would be upgraded into supervisory	EU finance ministers have discussed whether EU governments should emulate the US and conduct stress tests for individual banks' capital requirements. Peer Steinbrück, Germany's finance minister, indicated that there was little enthusiasm either for the US approach or for making the results of any stress tests public.	The Commission has proposed stricter requirements for the custodians of retail investment funds known as UCITS that could make it easier for investors to recover money in cases of fraud or fund collapses.	The Commission is working on a report on derivatives, which will encompass exchange-traded derivatives as well as OTC products. Expected on June 29, it will address what Brussels sees as shortcomings in how OTC derivatives have been regulated and suggest changes expected to be broadly in line with what Washington is pushing for.	The Commission is seeking to impose strict new disclosure rules on managers of all alternative investment funds, including hedge funds and private equity, as well as the portfolio companies owned by private equity funds. They are also looking to regulate leverage levels and impose stricter requirements on the custodians of fund assets.

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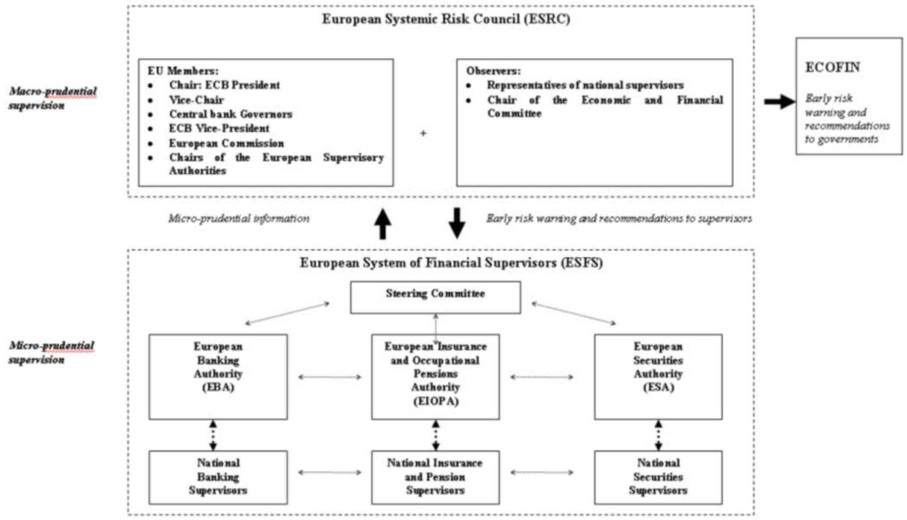
The future of regulation (1)

- Likely changes in financial sector regulation till end year 2010:
  - New definition of equity capital (Tier 1 capital)
  - Financial leverage limitations (internationally coordinated)
  - Aditional capital requested for systemically important banks
  - Aditional capital for market trading activities
  - Countercyclical capital requirements
  - Authomatic debt to equity conversion in case of trigger events (e.g. FI approaching insolvency):
    - Living wills, convertible contingent bonds (CoCo bonds)
  - Liquidity regulation
  - Harmonisation of the accounting standards (GAAP vs. IASB)
  - Supervision of the CRAs
  - The importance of systemic risks (ESRB in EU)
  - Regulation of the financial derivatives markets

A new European framework (1)



Sovereign debt

- Financial Times:
  - http://www.ft.com/cms/s/0/c71a3b60-73c4-11df-bc73-00144feabdc0.html#axzz1BP7k05Df

The euro area's debt crisis

The reckoning

% of GDP (unless stated)

	Gross government debt 2010 est	Gross government debt 2015 f'cast	Primary budget adjustment, 2010-15 f'cast	Net international-investment position, 2009	% of gov't bonds held abroad*	Ten-year gov't-bond yield†, %
Greece	140.2	165	10	-89.1	58.0	11.3
Ireland	97.4	125	13	-102.5	54.2	8.3
Portugal	82.8	100	8	-113.2	66.0	6.8
Spain	64.4	85	10	-95.7	38.7	5.5

Sources: *The Economist*; European Commission; IMF; Citigroup; Thomson Reuters *Q3 2010 †January 12th 2011

- The Economist, 15. Jan. 2011

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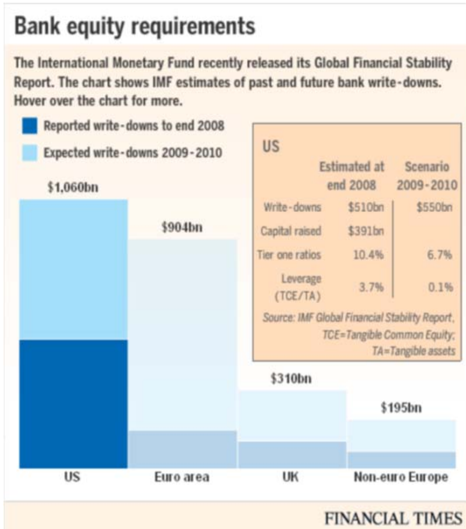
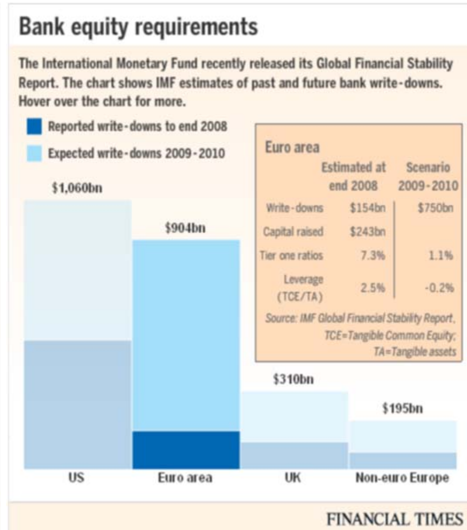
Damage to the financial sector (4)





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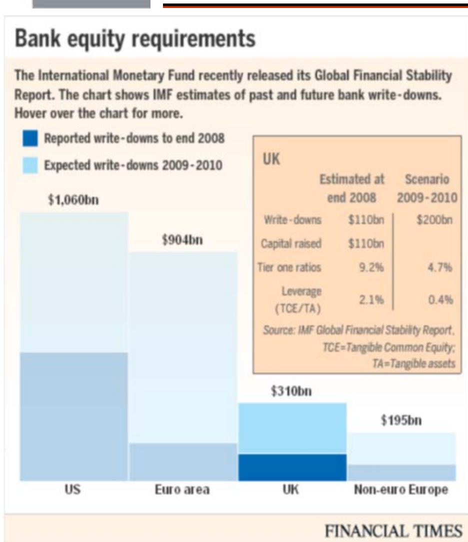
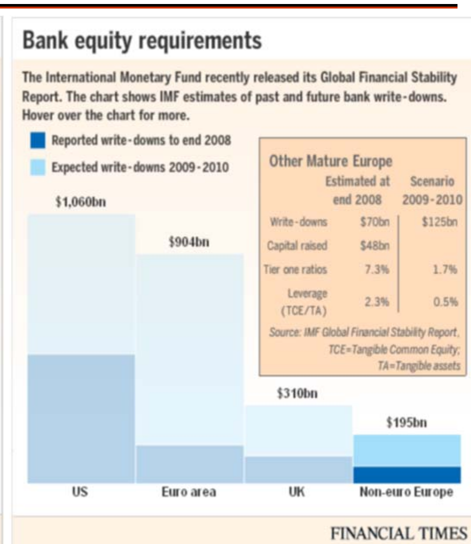
Damage to the financial sector (5)





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The new shape of regulation

(FT, 22. June 2009)

	Systemic risk	Bank capital	Consumer protection	OTC derivatives	Hedge funds
US	The Federal Reserve would be charged with monitoring large interconnected financial companies to ensure that they are not putting the entire system in danger through their own unsafe balance sheets. The work would be complemented by a new oversight board.	Raising capital requirements is an important pillar of US - and one that can be accomplished without Congress. All financial institutions will have to hold more capital and use less leverage; the most systemically significant will have to hold the most. The administration is also committed to tightening the rules internationally through changes to the Basel accords.	The Obama administration has proposed creation of a Consumer Financial Protection Agency to protect consumer purchasers of all financial products and services not already regulated by the SEC, including mortgages, credit cards and insurance annuities. It would set standards for intermediaries, such as mortgage brokers, and protect consumers from abuse and deception.	Congress is writing legislation that would require "standardised" OTC derivatives to be processed through clearing houses, which step in when a party to a trade defaults. Although some OTC derivatives are already cleared, many other types - including those blamed for exacerbating the financial crisis - are not, exposing the financial system to potentially huge risks in the event of defaults.	The Obama administration has proposed requiring all managers of hedge funds to register with the Securities and Exchange Commission. They would be subject to new record keeping and disclosure requirements and the SEC would be permitted to conduct regular periodic examinations to monitor compliance. (Needs Congressional approval)
EU	The European Commission is considering the creation of a systemic risk council to assess and warn of threats to financial stability in the region, and a new system of financial supervisors which will oversee individual banks and financial firms. On the latter front, three existing pan-EU co-ordinating committees would be upgraded into supervisory	EU finance ministers have discussed whether EU governments should emulate the US and conduct stress tests for individual banks' capital requirements. Peer Steinbrück, Germany's finance minister, indicated that there was little enthusiasm either for the US approach or for making the results of any stress tests public.	The Commission has proposed stricter requirements for the custodians of retail investment funds known as UCITS that could make it easier for investors to recover money in cases of fraud or fund collapses.	The Commission is working on a report on derivatives, which will encompass exchange-traded derivatives as well as OTC products. Expected on June 29, it will address what Brussels sees as shortcomings in how OTC derivatives have been regulated and suggest changes expected to be broadly in line with what Washington is pushing for.	The Commission is seeking to impose strict new disclosure rules on managers of all alternative investment funds, including hedge funds and private equity, as well as the portfolio companies owned by private equity funds. They are also looking to regulate leverage levels and impose stricter requirements on the custodians of fund assets.

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A new European framework (1)